BEFORE THE INSURANCE COMMISSIONER
OF THE STATE OF WASHINGTON

In the Matter of the Application regarding the Conversion and Acquisition of Control of Premera Blue Cross and its Affiliates	Docket No. G02-45

Adjudicative Hearing
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Day 3
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Taken Before:

Kristin DeLyn Manley, RPR, CCR
Registered Professional Reporter
Capitol Pacific Reporting, Inc.
2401 Bristol Court S.W.
Olympia, WA 98502
(360) 352-2054
capitol@callatg.com
www.capitolpacificreporter.com

APPEARANCES

COMMISSIONER'S TEAM:	MR. MIKE KREIDLER WASHINGTON STATE INSURANCE COMMISSIONER
	JUDGE GEORGE FINKLE SPECIAL MASTER
	MS. CAROL SUREAU DEPUTY INSURANCE COMMISSIONER
	MS. CHRISTINA BEUSCH ASSISTANT ATTORNEY GENERAL
FOR PREMERA:	MR. THOMAS E. KELLY, JR. ATTORNEY AT LAW PRESTON GATES & ELLIS
	MR. ROBERT B. MITCHELL ATTORNEY AT LAW PRESTON GATES & ELLIS
	MR. FRED TAUSEND ATTORNEY AT LAW PRESTON GATES & ELLIS
	MS. RAMONA EMERSON ATTORNEY AT LAW PRESTON GATES & ELLIS
FOR THE OIC:	MR. JIM ODIORNE ASSISTANT INSURANCE COMMISSIONER
	MR. JOHN HAMJE OIC STAFF ATTORNEY SPECIAL ASSISTANT ATTORNEY GENERAL
	MS. MELANIE deLEON ASSISTANT ATTORNEY GENERAL
	MR. JOHN ELLIS SPECIAL ASSISTANT ATTORNEY GENERAL

APPEARANCES
(Continued)

FOR THE INTERVENORS:	MS. AMY McCULLOUGH ATTORNEY AT LAW ALASKA INTERVENORS
	MS. ELEANOR HAMBURGER ATTORNEY AT LAW PREMERA WATCH COALITION
	MR. JEFFREY COOPERSMITH ATTORNEY AT LAW WASHINGTON STATE MEDICAL ASSOCIATION

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P R O C E E D I N G S

JUDGE FINKLE: Good morning. Please continue.

MR. HAMJE: Good morning, Commissioner, Your Honor. Good morning, Mrs. Novak.

THE WITNESS: Good morning.

CROSS-EXAMINATION

BY MR. HAMJE:

Q Ms. Novak, I wanted to ask you just a few questions about your testimony from yesterday, but I wanted to start off with just asking you whether - to make sure you are not suggesting that Premera is not financially healthy?

A Oh, absolutely not. No, absolutely not.

Q And you are also not suggesting that Premera is in a weak financial position?

A They are capitally constrained. That is different than a weak capital position. They are not - actually, I'm glad you asked that question because the question often comes up do they have to do this. And the truth of the matter is if they were in a very weak capital position, we wouldn't be in this room. We would be somewhere else.

Because they can't do some of the things that they need to do to put capital contingency plans in place when you are

in a weak capital position. So I'm glad you asked that.
Q Now, at the time of your deposition, which I believe was taken last November, you had not prepared any projections regarding whether the capital constraints will lead to any financial problems for Premera; is that right?
A That's correct.
Q Is that still the case?
A That's still the case.
Q And also, at that time, you hadn't seen any of Premera's financials?
A I have seen their balance sheet. I have not seen any of their projections.
Q And that's still the case as well; is that right?
A That's true.
Q And you haven't analyzed Premera's business plans at all, have you?
A No, I have not.
Q And also when you - I want to make sure about this. You haven't reviewed Premera five-year forecast as well, have you?
A No, I have not.
Q Your testimony in this area is generic based upon your experience with other Blues plans; is that right?
A That's correct. And with capital planning, contingency planning, risk management in general. So I'm familiar with

the types of contingencies insurance companies and all companies try to protect themselves against going into the future.

It isn't - when you look at a risk management program, it isn't what you can foresee or what you predict, you really look to protect yourself. It is really the not-probable events, it is the possible events that you have to make sure that you can navigate the waters around and that you can protect against. It is to give yourself a little bit of a cushion for the bigger bumps, not the ones you are predicting.

Q You have no specific knowledge about the kinds of capital expenditures Premera intends to make in the next three to four years regardless of whether or not it is allowed to convert, do you?

A No. No. Again, my testimony is generic from knowing that companies always have a backlog of projects and that there will be some projects, hopefully not important ones, that they will have to put off, as all companies do.

Q And, of course, you haven't been made privy to Premera's strategic plans, have you? Is that right?

A No, I have not.

Q And I gather you are not aware of any capital expenditure that Premera needs to make for which there is no capital?

A No. I do not know.

Q And you haven't seen any evidence that Premera intends to pass risk onto employers and providers in order to ease its capital position, have you?
A I know nothing of their plans.
Q And other than as an option mentioned in some of the other reports, you have seen no sign of Premera eliminating nonprofitable lines of business; is that right?
A I have not reviewed any plans or documents or history where I have seen that, no.
Q And you are not aware of any lack of sufficient capital at this time?

MR. KELLY: Objection. Vague as to what - vague and ambiguous question.

JUDGE FINKLE: Sustained.

Q (BY MR. HAMJE) You are not aware of any lack of sufficient capital that Premera would need to use at this point in time to invest in its capital needs?

MR. KELLY: Still same objection. It is vague.

JUDGE FINKLE: Sustained. You just need to be a bit more specific if you wish to ask that question.

Q (BY MR. HAMJE) You are not aware of any capital needs for which there is no capital for Premera to utilize?
A I am not aware of a capital expenditure that they need to make that they cannot make at this time.
Q Now, given that Premera, as you put it, is capital

constrained, how was Premera able to spend 128 million dollars in developing Dimensions, which is a state of the art system?

A Well, one, that's in the past. From the testimony that I heard - again, I did not review their past history investments - they did a sale and lease-back, so they minimized the effect of that investment on their capital and, therefore, their risk-based capital percentages.

With a sale and lease-back it is a way of taking an asset and getting the value of that asset admitted onto your balance sheet and then paying for it through the lease going forward.

Q Are you aware of any capital projects that have been postponed by Premera?

A No, I am not.

Q Isn't it true that all companies, including public companies, take into account their balance sheets when capital investment decisions are being made?

A Yes.

Q In your testimony yesterday you indicated that there are a number of advantages regarding raising capital through stock. Do you recall that testimony?

A Yes, I do.

Q And I wrote down as many as I could in that time and I want to go over them with you to make sure I have them all.

Raising capital through stock provides an immediate influx of capital; is that right?
A That's correct.
Q And another one is the equity market can be a source for future funding where if the company has a temporary problem, the company can resolve it through the equity markets?
A As long as they are still in good financial position, yes.
Q The capital through stock doesn't have to be repaid?
A Correct.
Q It is the least expensive of all the alternatives?
A I don't know that I said it was the least expensive. I said there were the three criteria and when you look at all three of those criteria, it measures up the best. I have not done an analysis of the projected cost or the net present value of the cost of all of those alternatives to meet a specific capital need. I would have to do that. My gut reaction is it is going to come out on top, but I have not done that analysis.
Q Were there any others that I missed?
A No. I --
Q Okay. When you talk about these advantages, upon what experience are you relying?
A Both experience and education. The experience would be working with Blue Cross/Blue Shield plans who did get into a very bad capital position when I was at the Blue Cross/Blue

Shield Association and working with some of the plans over a number of years trying to improve that position, looking at what we could do to help, you know, give them ideas on what to do.

The Association doesn't actually provide any help per se, but, you know, we have some experience, looking at their own strategic plans and how those evolved over the years and which ones worked and which ones didn't.

Q I wanted to ask you about the cost of seeking capital in the equity markets. Do you have any familiarity with those costs?

A I am not an expert in that area.

Q I see.

A I'm not an expert in that area.

Q Are you familiar at all with the fact that there might be underwriting costs? Is that something that you would know anything about?

A I am familiar with the cost. I have gone through projections. I have seen projections in other situations, but if you were going to ask me the magnitude and inventory of the cost, I would not be able - I'm not an expert in that area.

Q So we would have to go to someone else to get that information?

A You would have to go to an investment banker, yes.

Q But let me ask you this: Isn't it true that once the stock is issueed and sold when a company goes public, doesn't that mean that somebody else owns part of the company?
A Yes, and they are represented by the board of directors.
Q Yesterday you also talked about an underwriting cycle. Do you recall that testimony?
A Yes, I do.
Q And you described it as being the risk of Premera mispricing in a down cycle; is that accurate?
A Mispricing in an up cycle, too, because the underwriting cycle is really the profitability. So even in an up cycle, if you misprice, if you miss your estimate.
Q Doesn't the cycle you speak of reflect the entire marketplace of health carriers or companies?
A The cycle seems to move in last step, although not every company is moving exactly with the same cycle or the same depth of the cycle. I guess it would be similar in some respects to the stock market, it goes up and down, but any individual stock can move, more or less, and sometimes in the opposite direction.

It depends on what the company is forecasting and what it is able to do in the marketplace both in terms of competition and regulation.

Q But you are not suggesting that the cycle applies only to Premera --

A Absolutely not.
Q -- is that correct?
You also talked about increasing profitability as an alternative method of raising capital; is that right?
A Yes.
Q And isn't - isn't that the method that Premera is using now as a nonprofit essentially?
A That is really the only alternative that they have been using right now.
Q And you stated, if I recall correctly, that this - increasing profitability is basically a long-term solution; is that right?
A Right.
Q And what I wanted to ask you about is when you say, "long-term," what - how long are you talking about?
A Very long I think in this particular case. Just because from the testimony I have heard, current profit - profit levels are at less than two percent. I think that just because of increases in increased capital, the profit margin is going to have to be more than that.
So then you are talking about adding profit on top of that in order to build up your capital and therefore your risk-based capital percentage. I have not done any modeling, but it's - it's going to be a number of years before you could hit the targets that they are talking

about.
Q Is five years too short for long-term, in your opinion?
MR. KELLY: I will object. This is vague. Is this general or compared to what?
JUDGE FINKLE: Sustained. Please rephrase.
Q (BY MR. HAMJE) Again, when you talk about long-term, could you give me an idea - is it more than five years, more than 10 years? That's what I'm asking.
A I really hesitate to answer without modeling it out, so I will just say my impression would be more than five years --
Q Okay.
A -- to hit the targets they are talking about.
Q Now, you - yesterday you also talked about surplus notes as another alternative.
A Yes.
Q And you state in your - and you indicated that even if Washington were to allow Premera to receive a surplus note --
A Mm-hmm.
Q -- the state regul- - the state regulator of the plan providing the note may not approve its issue; is that right?
A That's correct.
Q What I would like to ask you is to help me understand exactly how you envision the way a surplus note transaction operates.

First of all, who would be the one who would actually issue the surplus note if Premera were involved in this process?

A In my experience with surplus notes, it has been between Blues plans. I have talked to investment people about other cases, but the ones that I'm personally familiar with, it was a Blue Cross/Blue Shield providing a surplus note to another Blue Cross/Blue Shield plan in another state who needed capital.

Again, there is a concern among the Blues that they all stay strong. And so it was done in order to help a fellow Blues plan out.

Q Well, then, so I understand, you would be - the way you are describing it, it would be another Blue Cross/Blue Shield plan would give another surplus note to Premera; is that what you are suggesting?

A I'm saying in my experience with - that's my experience with surplus notes. Certainly surplus notes could be issued by other entities besides Blue Cross/Blue Shield plans, but my experience is between Blues.

Q Then who would get the cash, the capital?

A Premera.

Q Who - and so then the - the way you described it then, the surplus note would be given to Premera and then the cash would be given to Premera; is that what you are suggesting?

A The cash would be given to Premera, but it doesn't come in as a liability. It comes in similar to paid in capital. So it increases the capital of the plan without increasing the liability.
Q Well, I want to get to that in just a minute, but wouldn't it - wouldn't it be that Premera would give the surplus note to the person that would give Premera the cash? Wouldn't that be the way it operates?
A The other plan would be the noteholder. They would hold the note, just like a loan.
Q So Premera would issue the note?
A Yes.
Q Okay. And then the cash would then be paid to Premera?
A Correct.
Q Okay. I wanted to make sure I understood that correctly.
A Sorry.
Q Now, let's talk about how it would be recorded on the - on Premera's books.
A Mm-hmm.
Q What is your understanding about how - how - how that would be done?
A As I said, it - it - I guess what is the most similar is a paid in capital where instead of showing a liability, which a loan or a debt instrument would show up as a liability, so you would have the cash and you have the liability and the

difference would net out and there would be no increase in capital. It would come in as paid in capital and therefore it would increase capital and therefore risk-based capital.

Q When would the note become a liability?

A It becomes a liability at the time any part of it is scheduled to be repaid and has been approved to be repaid. Typically in these notes the Commissioner, in this case - in Premera - would have to approve any repayments. And at the point where there is a payment due and approved to be paid, that becomes a liability. And typically the interest becomes a liability when it is due.

Q Just for clarification, I wanted to ask you this: Would the note basically have language to the effect that the - the obligation to repay would not arise until the surplus of the company got to a certain level?

A That can be one of the conditions of the note.

Q And so until it got to that level, it would not necessarily have to be reflected, except as maybe a footnote in the - in the statutory accounting forms?

A That's correct. And that's a good point. It does have to be reflected as a footnote.

Q Ms. Novak, at the time that you gave your deposition, you indicated to me that you had not read the Washington State requirements regarding the RBC; is that correct?

A That's right.

Q Have you since remedied that?
A I have.
Q In your - in your prefiled direct testimony, you state that "Washington has two regulatory RBC limits, one at 200 percent for corrective action and another at 100 percent for more drastic action;" is that correct?
A That was in my prefiled testimony. And it actually has more than two, but it does have two.
Q Oh, so there are more than two; is that correct?
A Yes.
Q There are actually four; is that correct?
A Yes, that's correct.
Q We have here in Washington the company action level; is that correct?
A That's correct.
Q And then the regulatory action level, which is 1.5 times?
A Correct.
Q That would be 150 percent?
A Mm-hmm.
Q And then, of course, the control level, which is 100 percent?
A Authorized control level, correct.
Q Yeah, authorized control level.
And then the mandatory control level?
A Correct.

Q And that's .7 times, 70 percent.
A Correct. And that's the point where the Department of Insurance must take over a company and, of course, no company wants to be at that level.
Q Now, you also stated in your prefiled direct testimony also, I think yesterday as well, that based upon your experience with other Blues plans, an RBC of 500 percent or above would be an appropriate target for Premera?
A I said that the plans that I have worked with and nonBlue plans that I have worked with had 500 percent as the minimum capital that they wanted to ever go to. So that was their bottom target, not the mean, not the average that they wanted to be at.

And so plans that I have worked with in similar situations, in order to actually calculate target, either a minimum or a mean, you really have to do some pretty sophisticated actuarial modeling and that's something - I have not done that for Premera.
Q And I wanted to follow up on that. In connection with your engagement, Premera did not ask you to provide the specific RBC target for Premera using actuarial and financial modeling?
A No, they did not.
Q And if you had been asked to do so, you could have provided a specific RBC target for Premera; is that right?

A I could have done that.
Q And target levels of Blue Cross/Blue Shield plans is not information that is normally made public, is it?
A No. It is only something their consultants internally discussed. You can maybe make some assumptions looking at what the historical RBC levels are, but you don't really know what the internal targets are.
Q And when you talk about Premera's target RBC level being lower than those set by most Blue Cross/Blue Shield plans, your statement is based upon an inference based upon what other companies' levels are; is that correct?
A I don't know that I have said that. You would have to show me that I have that their target is lower. Their actual is lower and I think I have said that a target of 500 percent for a minimum RBC would be appropriate. It seems to me we have actually - maybe I did say it was a target and have corrected myself that that's, again, an implication based on where the RBC of other plans are.

And their RBC certainly is lower than the RBC of most of the Blue Cross/Blue Shield plans, or most of the comparable plans. That's the actual versus the target.

Q Well, let's go ahead and make sure we clarify this for just a minute. If we can go to your testimony - excuse me.

MR. HAMJE: If I may approach the witness?

JUDGE FINKLE: Yes.

MR. HAMJE: I have the original deposition for Ms. Novak right here as well. Do you all have that as well?

JUDGE FINKLE: We do not.

MR. HAMJE: Let me go ahead and hand it to you all.

Q (BY MR. HAMJE) And, Ms. Novak, I'm going to hand you a copy along with the exhibits.

MR. KELLY: Your Honor, before we go any further, I think it is important that we have in front of us what the question is that Mr. Hamje thinks he needs clarification on because there is no need to turn to the deposition unless there is some - some difference between the deposition and her testimony today.

MR. HAMJE: And I think when I have a chance to go into this deposition testimony, we will see exactly to what extent the statement needs clarification.

JUDGE FINKLE: I will listen to the question and then your objection may be appropriate.

Q (BY MR. HAMJE) Ms. Novak, would you please turn to Page 64 of your deposition?

MR. KELLY: I'm going to have to object. There is no question in front of the witness. And reading the deposition, until there is a question of which there would be a comparison, I don't think is appropriate.

MR. HAMJE: Forgive me, but I asked a question and the answer was given. That's what I want to talk about.

MR. KELLY: Then if I may ask the court reporter to read it back to see what the question that Mr. Hamje asked that he didn't have understanding. And what the answer is is more important.

JUDGE FINKLE: You are seeking the question - the last question and answer; is that right?

MR. KELLY: Which presumably is . . .

(Reporter read back question and answer.

MR. HAMJE: If I may proceed?

JUDGE FINKLE: Well, you can - you can seek comparison to a particular deposition section and then I will hear from Mr. Kelly.

MR. HAMJE: And I would like to go to Page 64 of Ms. Novak's deposition starting on Line 7 through line 16.

MR. KELLY: If I could just read that for a minute, please.

JUDGE FINKLE: Sure.

MR. KELLY: I will object to any introduction or discussion of this because there is nothing contradictory to what is said here than to what the witness testified to on the stand.

JUDGE FINKLE: You will have to ask the question

again closely similar to the question that you asked at Line 7 in the deposition. At this point, I'm going to sustain the objection. I don't see the direct impeachment. I'm just trying to give you a little guidance here. I don't --

MR. HAMJE: I understand. I could use all the guidance I could get, Your Honor.

JUDGE FINKLE: If you ask a similar question and there is different answer, then we will use the deposition.

MR. HAMJE: Then I will ask it.

Q (BY MR. HAMJE) When you talk about the fact that Premera is well below the target set by most Blue Cross/Blue Shield plans, can you give me a sense of what those targets are for most Blue Cross/Blue Shield plans?

A Okay. And I do not know what the target - internal target is for most Blue Cross/Blue Shield plans. I can only make assumptions that because most Blue Cross/Blue Shield plans are consistently above the 500 percent target - which is not Premera's target from what I understand, they have not actually told me. I have heard testimony as to what their target is.

But the 500 percent that I had been talking about is below the historic percentage for most Blue Cross/Blue Shield plans, so I have to assume the 500 percent is below the target of those Blue Cross/Blue Shield plans.

Q Okay. You also yesterday talked about the increase in

Premera's RBC level from 2002 to 2003; is that right?
A That's correct.
Q That was an increase of approximately 27 points; is that correct?
A That's correct.
Q Would you characterize an increase to that extent in RBC level to be significant in the context of Premera's RBC level?
A No.
Q Why not?
A The seven percent increase in - seven percent - I mean, it is going in the right direction. And thank goodness it went in that direction because if it had gone in the other direction, they would have been very close to the 375 percent.

But as - looking at what happened to other Blue Cross/Blue Shield plans in that same period and the average Blue Cross/Blue Shield plans, it is on the low side as far as an increase. And the seven percent increase, you know, it is not outstanding.

Q It is not significant?
A It is not significant.
Q How and to what extent funds are raised to an IPO impact the company's RBC, that depends on how those funds are utilized; is that correct?

A On day one when the funds are raised, it increases the RBC. Now, if the funds are then spent, it depends on what they are spent on and if that's admitted - an admitted answer.
Q So if they are put into bonds, the RBC would increase, would it not, and there would be very little decrease; is that right?
A Very little decrease, I'm assuming, for bonds. Yeah.
Q If its capital expenditure, the impact depends on whether the assets are admitted and if they are depreciated; is that right?
A Correct.
Q If they are used to create more profit, then the RBC could increase over time; is that right?
A Correct.
Q Isn't the critical factor for a short-term impact on RBC that funds be applied to an admitted asset?
A To preserve the initial increase, they would have to be applied to admitted asset or a sale lease-back type situation, if it - if the whole amount was preserved to preserve the full amount.
Q For instance, investing in junk bonds, for instance, that would not increase the RBC as much as it should because of the covariant formula; is that correct?
A I'm sorry. Could you rephrase that?
Q Yes. If - if - if the funds were invested in junk bonds,

that would not increase the RBC as much as it - you might think because of the covariant - covariant formula; is that right?

A Let me explain how the covariant formula - and if anybody wants to talk about hypotenuse and fourth and fifth dimensional space, we can talk about what the covariant really is.

But the covariant formula muscles the effect of any of the risk besides the underwriting risk. The underwriting risk or the risk based upon incurred claims derives the formula. So I would say that if you invested in junk bonds, which would increase your risk in the asset risk category, because you are investing in an asset that is riskier, so it would increase your required capital, that the covariant formula actually decreases that effect more than I think it should.

So you would end up with more capital because of the covariant formula than you probably could because you have more of a hit because of those junk bonds.

JUDGE FINKLE: If you want the Commissioner and me to understand, you need to ask some more questions.

THE WITNESS: I think John understood the answer.

MR. HAMJE: Well, barely. But I thought it would be useful to just talk about the covariant factor for a minute, because that's correct, it muscles the effect.

MR. KELLY: Well, now I think I have the opportunity to object to the attorney testifying at this point.

JUDGE FINKLE: Sustained. But I'm not - at least speaking for myself, I'm not sure I understand enough to even accept that, if I weren't striking it.

MR. HAMJE: Let me go on then.

JUDGE FINKLE: Yeah.

MR. HAMJE: I didn't really want to spend a lot of time on the covariant formula.

Q (BY MR. HAMJE) How much capital would Premera need to get to a 500 percent RBC level?

A I have not calculated that number based on the 433 percent RBC. So I can tell you it was about 72 million at the end of 2002 based on the 406 percent RBC, based upon everything at that point in time. I haven't recalculated it.

Q Would it be less now based on the 433 percent RBC?

A It should be, yes.

Q Are there any negative impacts of raising this much capital?

A There could be.

Q Can you think of any?

A Well, the first is there is the cost of capital, you know, so there is a cost there. Again, I think it is less than some of the alternatives. And then I guess as you were bringing up earlier, it is what you spend it on. You know, it is a matter of once you have the capital, how you

preserve it, what you use it for, if you use it wisely so that you are getting a return.

Q What about dilutions to existing shareholders in the stock?

A As - I - I know the answer to this. I hesitate to answer because I'm not here as an expert in that, so . . .

Q So we should talk to an investment banker?

A I would, yes.

Q One of the other alternatives you discussed was that about merger acquisition.

A Mm-hmm.

Q And you talked about the loss of autonomy as a disadvantage for merging with another company for the purpose of generating capital. Do you recall that testimony?

A Yes, I do.

Q Why do you suggest that the loss of autonomy is a disadvantage?

A It is a disadvantage to the current management team that then loses the decision-making power that they might have had before. There is sometimes a disadvantage in it to the regulators because they lose a little bit - if, again, a merger with a company out of the state - because they may lose some control over what the company does, especially depending upon how the merger is structured.

For instance, if it is structured into a holding company and the holding company - the parent entity is domiciled in

another state, the regulators - in this case, in Washington and Alaska - may lose some of the regulatory authority that they now have.

Q Are you suggesting that a company that is part of a holding company group that is a subsidiary of an out-of-state holding company group, that the Insurance Commissioner doesn't have much control over a domestic member of that holding company group?

A That's been my experience.

Q In what respects does the Commissioner not have control?

A Because the Commissioner in the state of the holding company often has at least the last say as to transactions either - of that holding company because it is domiciled there. It has been a problem in some other states.

Q Are there any other reasons that you suggest that loss of autonomy may be a disadvantage?

A I think they all fall in those two categories, all of the specifics I can think of.

Q Do you see any disadvantages with the respect to deterioration in member services, for instance, subscriber services?

A That certainly can happen. I'm aware of one merger situation where the computer system that was chosen to be their surviving, if you will, computer system, the one that was chosen was actually the one that provided the lesser

service and therefore the service went down in the other - in that case it wasn't a state, it was in the other territory, but --

Q Are you --

A Oh --

Q Go ahead.

A You can't predict, but that obviously can happen.

Q Are you also aware of situations where the services or performance of a target company have improved after acquisition?

A Absolutely. And that's really what you hope for.

Q In fact, aren't there some good examples in some of the Anthem acquisitions where that has taken place?

A I can think of a couple of examples.

Q Cirrilian (phonetic), for example?

A Mm-hmm.

Q Rocky Mountain?

A I can't speak actually to those two specifically. I can't confirm or deny, but certainly I do know of some that I believe have improved.

Q Such as - can you give me an example, please?

A In Maine and Connecticut.

Q In fact, Maine was one of the ones I was thinking of, too.

A Okay.

MR. HAMJE: Ms. Novak, that's all that I have at

this time. Thank you.

THE WITNESS: Okay.

CROSS-EXAMINATION

BY MR. COOPERSMITH:

Q Good morning, Ms. Novak. How are you?

A Good morning.

Q Ms. Novak, are you familiar with - are you familiar with the RBC levels for Regence Blue Shield?

A I believe I included them in my report. I don't remember them at this time.

Q Would you say it is about 600 percent? Is that your recollection?

A I don't - I would have to look at the exhibit. I'm sorry.

Q No problem.

And, Ms. Novak, is it your experience that Blues plans must be for-profit to meet the Blues Association's requirements for RBC levels?

A Must be for-profit --

Q In order to meet the Blues Association's requirements for RBC levels?

A No. They don't have to be for-profit to do that.

MR. COOPERSMITH: No further questions of this witness. Thank you.

JUDGE FINKLE: Other Interveners?

MR. COOPERSMITH: No, Your Honor.

JUDGE FINKLE: Redirect?

MR. KELLY: I have just a few.

REDIRECT EXAMINATION

BY MR. KELLY:

Q There was a discussion about the possibility of increasing RBC levels through increasing profitability. And I wanted to ask you about what factors - other factors might come into play over a period of years that might undercut efforts and projections to increase profitability.

A I guess it would be all the factors that could inhibit any projections of profitability. There is just - all of the factors that go into profitability, income, expenses, are variables. And so you may not be able to increase premiums as much as you would like or could predict just because of market forces.

You may not be able to cut expenses just because of, again, market forces, either the work force that you are hiring or your incurred claims. There is only so much that you can do to control or lower, you know, your claims expense.

Q And so is it possible that you could have an increase for

one year or two years, which could be lost, and then in the subsequent one or two years --

A Absolutely. And that obviously is the underwriting cycle and happens all the time.

Q Okay. And so how does that compare, then, in terms of benefits with the use of going to the equity market for obtaining capital to create an increase immediately in your RBC?

A Well, the disadvantage of using profits to increase your RBC is you can predict the profit, you might not realize it. And it takes a long period of time to actually build up profits.

And in the plans that I have worked with that had problems, it was very difficult. They had to come up with other methods. It was very difficult, even over three to five years, to increase their capital through profits significantly.

Q I would like to talk a little bit about surplus notes. Are there limits to the amount of capital that can be raised through surplus notes?

A Sure. Yes, there is.

Q Can you give us anymore indication --

A No.

Q -- of that?

A No. I do not know what the current market is.

Q Is this use of capital notes as a source of - use of surplus notes as a source of capital, does it occur very often in this case?
A Less and less.
Q Why?
A Less - it actually was common in the early '90s for the Blues plans to help each other out when they got into financial problems. More and more states, even that have laws on the book that allow it and how to do it, the regulators are disallowing it because of some bad situations that have happened in the past. And regulators are not permitting it.
Q So is it the effect that the company that is giving the capital or the cash to the requesting company is having a diminution in its own capital level?
A I'm sorry. Is that why they are not available?
Q No. Is that the way it works mechanically? Would that be an impact? If you decide we are going to help out Premera out of the goodness of our hearts and we are going to agree to a surplus note, what impact does that have on the financial and capital position of the company that agrees to do it?
A It leaves their capital position pretty much the same because they can often show that as an asset.
Q I see.

A And it is one of the reasons some regulators don't like surplus notes because it looks like you are making capital out of thin air.
Q So that money that they are giving to Premera they wouldn't then have to improve services for their own subscribers?
A Absolutely. They - obviously that is a, quote, investment that they are making.
MR. KELLY: Excuse me.
Q (BY MR. KELLY) And Mr. Hamje asked while maybe you don't have to pay it back for a long time, what would induce a company to give a lot of money to Premera for a long time without getting a lot of interest or other benefit out of it?
A Really it used to be just to help a fellow Blues plan out, but nowadays, again, that is more and more difficult. It is, as you were pointing out, an investment and they want a return on it.
Q Okay.
MR. KELLY: Excuse me.
That's all I have. Thank you.

RECROSS-EXAMINATION

BY MR. HAMJE:

Q Let me ask you a question about surplus notes again. Is it your understanding that surplus notes are interest-free?

A No, no. As I said, there is interest when it is due. It has to be --

Q And isn't that - sometimes that interest is an attractive interest for a company?

A Well, like any note or loan, you can shop for the best rate you can get. And from my experience recently - and maybe we are getting to a point where we need to get an expert on surplus notes in the current marketplace - but from what I have been told recently, the interest rates have not been low when they have been available. But maybe they are out there. I don't know.

MR. HAMJE: That's all the questions I have. Thank you.

MR. COOPERSMITH: Nothing further from the Intervenors.

MR. KELLY: Just one question.

REDIRECT EXAMINATION

BY MR. KELLY:

Q The interest is only payable if the regulator approves the payment; is that correct?

A It depends on how the note is written. And some of them have been written that way. And I know of one case where the regulator did not approve the repayment of the interest, one of the interest payments. It depends on how the note is written.

Q That must have the impact of making people reluctant to give these notes out if there is a risk that they won't even get their interest back sometime down the road?

MR. COOPERSMITH: Objection.

MR. HAMJE: Objection.

JUDGE FINKLE: Sustained.

MR. HAMJE: In stereo.

MR. KELLY: I guess I will have to withdraw my question. No further questions.

MR. HAMJE: No further questions.

JUDGE FINKLE: Any follow-up?

MR. COOPERSMITH: No, Your Honor. Thank you.

JUDGE FINKLE: Commissioner Kreidler?

EXAMINATION

BY COMMISSIONER KREIDLER:

Q Ms. Novak, I was just curious in all of the discussion that we have had right now about raising capital, do you - are you under the perception or the feeling or - right now that - that effectively nonprofit health carriers are somewhat of an anachronism in the current environment?

A I'm sorry. Define anachronism.

Q Well, do you - do find them somewhat antiquated in the current environment that we find ourselves in or health carriers both in this state and nationally?

A Yes. They are disappearing. In the health area, the not-for-profits and the mutuals are minimally going to a structure that would allow them to go for-profit in the future or allow them to do an IPO in the future, even if they are not doing it.

They are trying to position themselves so that they can take advantage of an IPO when they need it or going to the equity markets when they need it. So even companies that aren't doing an IPO right now, many of them are positioning themselves so that they could in the future.

Q So your advice to any nonprofit carrier out there is that they should be looking at becoming a public company?

A I think it is part of every capital strategy that should be investigated. And from what I'm seeing, many, many

companies are deciding that's the best way for them to position themselves and their capital strategy. Obviously it is one of the alternatives that should be investigated and from what I can see, it is the most attractive one for many plans nowadays.

Q Would you say most?

A You know, I would have to do the math, but I think it is probably getting up to most. If you look at health plans just numbers-wise, you have a lot of small Medicaid-owned HMOs or hospital-owned HMO's, so if you looked numbers-wise, maybe not.

If you look premium-dollar-wise, looking at what has been happening over the last three years, I think you are probably getting close to most and I predict you are going to be at most soon.

Q Do you think that all states are essentially comparable in their - in their environments relative to that decision of making a conversion from nonprofit to a public company?

A I don't think they are all the same, no.

Q Would the State of Washington be different because it - it has a very strong historical basis in being nonprofit, whether it is hospitals or health carriers, and therefore the environment here may be different than other states where the pressures may be greater?

A I don't think when you are looking at a capital strategy,

that the position of the competition is the only thing that you are looking at, especially the competition today. I think you want to look down the road --

Q Mm-hmm.

A -- quite aways. And in that respect I don't think that the current condition in Washington State would be we should absolutely actually go this way or that way. One of the considerations - but because - I mention what you are saying, is many of the plans in Washington State are currently not-for-profit. That might not be true down the road. And even if it is true forever, that doesn't mean that going for-profit wouldn't be the wisest thing for Premera to do based upon its potential future contingencies.

Q So the State of Washington may be different than other states, but you are not in a position where you would say that that's necessarily true, but it could be, and that Washington may have an environment that is different than other states relative to not-for-profit as opposed to public companies; is that fair to say?

A It - I guess what I'm saying is it may and probably is different. It is certainly different than some other states, but the fact that it is different shouldn't have that much of an effect on the decision for Premera to go for-profit or that that's best thing for them to do right now from a capital perspective.

Q Is your opinion relative to the State of Washington based on what may be happening in the future more than what maybe is the current environment today?

A Based on what is happening in the future as far as the number of for-profit competitors and based on what could happen in the future, even if the competitors are all not-for-profit, on the contingencies that might face Premera in the future where having access to the equity markets would help them, even if all of the competition was not-for-profit.

COMMISSIONER KREIDLER: Thank you, Ms. Novak.

JUDGE FINKLE: Follow-up?

MR. KELLY: No.

MR. HAMJE: None, Your Honor.

MR. KELLY: May this witness be excused?

JUDGE FINKLE: Yes. Please step down.

MR. TAUSEND: Mr. Commissioner, Premera calls Dr. Thomas McCarthy.

DR. THOMAS McCARTHY, having been first duly sworn by the Judge, testified as follows:

JUDGE FINKLE: Please sit down.

DIRECT EXAMINATION

BY MR. TAUSEND:

Q Would you state your name, please, Dr. McCarthy?

A Thomas Richard McCarthy.

Q And where are you employed and in what position?

A I am a senior vice-president with National Economic Research Associates. We go by the name of NERA, the acronym NERA, consulting economist.

Q And what is NERA?

A It is an international firm of consulting economists. We are in nine U.S. cities and I think six or seven foreign countries.

Q Could you tell the Commissioner a little about yourself and your background, please?

A I am - I grew up in a rural area out of Buffalo, New York. I then went to college. My father was a college professor and I got free tuition at a small Catholic school called a Assumption College in Worcester, Massachusetts. I got a BA in economics from Assumption College.

After that I went to the University of Maryland on a National Defense Education Act fellowship where I got my masters and Ph.D. in economics and a love of lacrosse.

And then following that I taught at a school called Oakland University in Michigan. It began as the honors

college of Michigan State and became its own university. Taught their for years, all the time being a health economist and a health research - doing healthcare research. My dissertation had been in the primary care services area, so from the beginning, I had been a health economist. Following teaching, I went to the Federal Trade Commission for a year-and-a-half as a health economist. And about 20 years ago I was hired by NERA and I now am a senior vice-president and the head of the U.S. healthcare practice.

Q Now, your prefiled direct and your prefiled responsive testimonies have been served and filed in these proceedings. Do you adopt that testimony?

A I do.

MR. TAUSEND: On the basis of the witness's adoption of his prefiled testimony, which is marked as hearing exhibit Premera 20, and Premera 21, which is his CV, and the responsive testimony, Premera 25, we would now offer those exhibits.

MR. HAMJE: No objection.

MR. COOPERSMITH: No objection.

JUDGE FINKLE: Admitted.

Q (BY MR. TAUSEND) Dr. McCarthy, have you been retained on behalf of Premera to evaluate the economic issues raised in this case by the conversion, the proposed conversion?

A Yes, I have.

Q And what have you been asked to do?
A I put together a slide deck, only a few of which may be confidential information, but --
MR. TAUSEND: I think there is one in the direct and I will signal the witness and Your Honor when we come to that.
A But let me start with the first slide, which indicates the economic issues that I was asked to evaluate. The first issue - there were two - is question of is the proposed conversion according to the statutory language likely to substantially lessen competition or tend to create a monopoly in the health coverage business. The competition question.
The second issue is - and my conclusion there is no. The second issue is will the conversion be likely to reduce consumer access, whether that is the healthcare insurance or healthcare providers. And, again, the answer I found based on all of our analyses is no.
Q Dr. McCarthy, will you tell us how you approached both these questions, if there is something common to both the questions?
A There is. It is the moreover riding question of market power. If - if Premera does not have market power, the conversion cannot substantially lessen competition because the market structure is such that it is a competitive

business already.

Similarly, if Premera is lacking in market power, has no discretion to do anything but watch its bottom line, which is one of the concerns postconversion, then they will continue to have to watch their bottom line whether they are not-for-profit or for-profit. So the market power question I think joins both of these issues.

Q How do economists define market power?

A Well, I'm going to talk about it in two respects because Premera obviously acts in a couple of different roles. It is a seller of health insurance, charges a premium, sells healthcare coverage and it is a buyer of provider services, particularly the physician, hospital, nursing home type services they raise through contracts. So let's look at it from both the selling side and the buying side.

Q Okay. Let's start with the selling side.

A Okay. The selling side, the definition of market power is, first, the ability to raise premiums above competitive levels. That's the first indicia of market power, but it has to be in a profitable and sustained level.

In other words, anybody can raise prices. It could be a spike in price, but the question is can you keep that price up for a sustained period of time and make substantial profits as a result.

Q Why is that important?

A Because it would signal that there is no supply response to come in and cure the high price. Normally what we expect - the normal resilient competitive process would be there is a supply response and prices fall back down because more goods and services are available.

Q Okay.

A And that's what leads then to the third condition of defining market power and that is this is done - can you only do this by precluding expansion and entry because of - in this case, because rival insurers can come in and then they can undercut your attempted monopoly price increase.

Q And the buying side, is there a similar definition?

A Yes. From the buying side for provider services - in this case, of course, we are talking about reimbursement, so buyer market power would have to do with lowering reimbursements below competitive levels.

And that, again, has to be not just a one contract year where one party could hold up another party. This has to be on a profitability and sustained basis. It is done - it is accomplished by reducing input usage and you can only reduce input usage if you have driven prices so low that people won't contract and people - and you can't sell your product and also by precluding expansion entry. Because if it is a fairly low cost market, then new rivals can come in and take advantage of the low provider contracting prices and will

actually start to bid up those prices again. And that's essentially how the market is restored to normal reimbursement levels.

Q If a business tries to exercise market power, what is there in the market to check that attempt?

A Two important actors. One are the demanders or consumers, buyers, and the other would be suppliers. There are essentially three kind of supply responses that will cure supercompetitive price increases.

Let me just take a simple example and we can see what the categories are. The - let's assume - as an antitrust analysis usually begins, it begins with - suppose the firm in question, in this case Premera, tried to raise the price about competitive levels. That's the usual thought process.

What are the types of responses? Well, first the one we could think of most is the current rival out there selling the same product could just simply sell more, make more of it, sell more of it. The example here would be if Premera had tried to raise the small group product price, Regence or Asuris could sell more of its small group product. And there is where consumers then substitute from one to the other.

The second type of response goes by the sort of - you will probably hear a little bit about this - goes by the stilted name supply substitution. The concept is actually a

pretty straightforward concept. It says if - there can also be expansion by sellers who make related products.

So a simple example might be you have a car dealership, the car dealership has a premium car, a full-size car, a medium-sized car and decides to add - when prices go up for small cars, decides to add small car prices. So they are making related products, they decide to add essentially a line of business.

Similarly here there are two forms of supply substitution that will be interesting to us. One of them is following this example we have set out, a seller of large group coverage moves into the sale of small group coverage, just adds a line of business.

They have the network. They have the claims processing facilities. They have the relationships with brokers. They have all of the fixed assets they need and just simply add another - they would have to learn a little bit about the regulations, make their filings and get in business. That would be a product line of business extension.

The second one is sort of a branching out. A seller of small group coverage, say, in Western Washington could start to sell small group coverage in Eastern Washington and we will look at some examples.

That is - that is what I would call geographic supply substitution. I make the product in Western Washington,

offer it for sale, I know about the regulations, I know - I have a license in this state, I have relationships with providers. I simply go over in this instance to Eastern Washington and set up a new network or rent a network. So we have two types of supply substitution.

Q Okay. Is there another type of response beyond those two types of supply substitution and the demand substitution?

A Yes. There is what most of the economists focus on in antitrust analysis and that is the new entry. An entirely new insurer can come into the state. Let's say Humana, just to pick one that is not in the state in any significant way.

Humana obtains a license and begins to sell health insurance in some or all of Washington. So again if there is a supercompetitive price increase, if there is a market opportunity where a firm can make profits because prices have gone up, then there will be a supply response. Any one of these three supply responses can cure a supercompetitive price increase.

Q Can you tell us a little bit more about why supply substitution is so important to your analysis here in the market?

A Yes. The lessons really are for our analysis of competition in market powers. The lessons are insurers can readily offer other lines of business. This, again, has to do with the fixed assets. They don't need to bear a lot of what

economists call sunk costs. Those are investments you make but you can't get back.

Q Another way to talk about it is they have the facilities and tools to do a job slightly different than they are doing it?

A That's right. That's right. So it is efficient and relatively cheap if the market opportunity presents itself to offer a new line of business.

Secondly, because of this, it is much more sensible to look at the products and what we are trying to find out, who are the firms that can constrain Premera in its pricing. It is much more sensible to look at the firms that - and the products as bundles of closely related products. In other words, healthcare insurance as opposed to just small group or just individual.

And that leads us to the conclusion that supply substitute, that is those firms producing these supply substitutions, should be included in the market when you are figuring out who could constrain the price increase. Competition comes from supply substitutes, not just demand substitutes.

Q Dr. McCarthy, if an economist were to attempt to evaluate the competitiveness of a particular market without considering supply substitution, would you consider that evaluation responsible?

A No, I would consider it flawed. I mean, supply substitution

is part of the definition of the product market. And I guess I would - I would say two things. One, depending upon how you define a product market and you start to calculate shares, you get different kinds of share measures.

There is going to be - from my point of view, there is far too much emphasis on the measurement of shares. Market shares only tell you - market shares don't tell you what market power is. They only tell you that you should look a little further. You should look deeper to try to figure out why the mark share is what it is.

If you define a very narrow product like small group you define it by the line of business or you define this all health insurance product, you will get different measures in market share. But you can't overlook the main thing that you really want to know and that is is the competitive process working? Is the competitive process resilient? Is there an ebb and flow of competition with these supply responses that we expect regardless of the share at any particular moment for any particular product?

So the main thing I guess I want to say is there is too much emphasis on share and you really need to keep your - we have to keep our eyes on the competitive process.

Q And is what you are saying essentially that it is not a status thing, that's a dynamic process and that's the important thing to look at?

A That is.
Q Are we ready to talk about the selling side now in your analysis?
A Yes.
Q Okay. What approach did you take to examine the structure of the market on the selling side of the business?
A Well, when we - when we examine market power, we usually do it in two basic ways. One is look at the structure of the market to find out whether the structure facilitates a possible exercise of market power and then we look for evidence of market power, whether it has been exercised or not. In order to do that you first have to define the relevant market.
Q Let me stop you just for a minute. It is somewhat a technical term, so why don't you tell us what relevant market means in antitrust terms?
A Okay. In some ways it is quite a literal meaning. What is the market relevant to be look at in a case? In an antitrust sense, if you are worried about market power, you are worried about the market bean monopolized.
You have to ask yourself what is it that I'm worried about being monopolized? Am I'm worried about a single line of business? Am I worried about something different? What geography does it cover, et cetera?
So a relevant market as two assets. It has the product

aspect, what products are we interested in looking at and what geography. We came to the conclusion after our analysis, which we will go into in some detail, that the relevant market in this matter for analyzing market power in this hearing is the market for all health insurance products delivered or distributed, sold through commercial companies in the State of Washington, and that includes HMO, PPO, indemnity, fully-funded, self-insured.

It includes the commercial lines of business. It includes even the public-financed lines of business that the commercial entities compete to sell, like Medicaid Managed Care, Medicare Managed Care, et cetera.

Q Now, did you, in doing your analysis, identify those businesses presently who are offering those products and lines of business in Washington?

A I did. And this next chart is as of 2002 from the annual filings with the Commissioner's office. We - these are most of the players in Washington, but you can see that these various companies offer a range of products. Virtually all of them, with some exceptions, in the large group market, large group segment, offer more than one line of business.

So this is really a reflection of the supply substitution. It is efficient to offer more than one line of business.

Q In your analysis did you find anything that would keep

others from coming in, new entrance of others with new products or lines of business?

A No, what we - one of the things we did was to look first to see if there is any regulatory or operational sort of problem with coming in. And what we determined first was that there is no significant regulatory or operational barrier for offering new products for expanding into different territories or moving into different product lines.

We then also went out and looked for evidence of expansion. And what we found were instances, even though there has been no monopolization attempt, we still find instances of these supply responses.

Q And what are those instances?

A Well, let me look at some of them specifically. Product line expansion, we have - we have identified from the data - and you can see the Spokane Journal of business in one instance. We have identified companies that have added products in the last - well, '97 on, last seven or eight years.

The last one, as you can see on the list, is Asuris. In 2004 - they had some individual product sales in 2003, but they rolled out two new individual market products, individual segment products in Eastern Washington.

Q And Asuris is the nonBlue Regence affiliate in the 14

counties of Eastern Washington? ?
A That's right.
Q And they had previously offered what? That area?
A It was in the small group and I believe the large group business since about '98, and has now rolled out these two - one is sort of a high deductible and one a low deductible individual product.
Q Did you also find examples of geographic expansion?
A Yes.
Q Okay.
A I have split these because part of the concern we will be talking about today is Eastern Washington versus Western Washington, so I split these into examples of expansion into Eastern Washington and examples within an existing region.
And, let me be clear, that there is really no distinction between a company that would blank out from let's say Seattle all the way down to Vancouver, Washington. That is still a supply substitution expansion. Just because it is in the west, it is no different really than moving across the mountains. They are both branching out to serve different geographies when the opportunity avails itself.
Q And are there any inherent differences, structurally or otherwise, in terms of moving to Vancouver than moving into Spokane?
A No, not as far as the analysis. I mean, it all depends on -

if the market opportunity is better in Vancouver, Washington, than it is in Spokane, then you would expect a better supply response down the I-5 corridor than you would across I-90.

Q Having defined the relevant market as all commercial health insurance in the State of Washington, did you then proceed to make an estimate of market shares of Premera and its competitors?

A I did. Just as a matter of market structure, if you - if you find - and it is our finding - if the finding is it is all health insurance in the State of Washington, then the appropriate market share to look at is one that covers all of Washington.

We - because of the data available - these are taken from the - from the Washington State Hospital Association. They have profiles on the state health plans that come from the OIC's information. We find that Premera's share is 28 percent.

And let me just say that I have never - I mean, in all of my experience in antitrust - I have been doing health antitrust since about 1975 and in all my experience, I have never heard of a court or a federal antitrust agency or even a state agency that looks at the health insurance as anything other than a broad market for health insurance, not a market for, you know, lines of business, single lines of

business.

The only even close exception to that would be in the Aetna Prudential matter that the Department of Justice investigated. It argued that there was a separate market for HMO and PPO, but it never argued small group, large group lines of business. So broader markets are appropriate and the share here is 28 percent.

Q Assuming based on perhaps a different definition of the relevant market company such as Premera had a greater market share, would that lead you to a different conclusion necessarily on the question of market power?

A Not - almost certainly not. I mean, even - even the OIC's consultants in their depositions and their writings of - have used a number as high as 65 percent before they have started to even affirm market power. It was apparently a - something that Dr. Leffler also recommended to them, would have to be at least that high. Again, the share doesn't matter as much as the competitive process.

Q After estimating the market share in analyzing the question of whether or not Premera had market power, what did you look at next, Dr. McCarthy?

A Well, one of the problems with only looking at market structure, is you are kind of inferential. You are saying will this market structure support monopolization or not? And so what you would like to do, if possible, is look and

see if there has been any direct effects of attempted monopolization or pricing profit differences in the market, that is direct measures of market powers. So the next thing we did is start the analysis of direct effects.

Q And how did you go about doing that?

A Well, a simple question would be does Premera charge more than other insurers, higher premiums than other insurers in the state? Are they significantly higher that might signal that they have - we are talking, of course, about the ability to raise price above competitive levels.

What we did is run a regression, which is a statistical technique. Regressions are complicated, but they are very useful in the sense that they let you hold constant a lot of the factors that might otherwise affect premiums.

So, for instance, if you have a rich benefits package, that is going to require a higher premium - well, we hold that constant, as you can see in the second row, you can see medical expenses per member. We want to know what the premiums per member are. Part of what explains that is medical expenses per member, if it is a rich package and you can see that that is positively related.

We held a number of the different characteristics of the insurers constant and we put in a variable that is highlighted there, which signals whether this was a premium charged in our regression analysis, a premium charged by

Premera or not.

And what we find is Premera's premiums are not statistically higher, significantly higher or lower than other insurers, and that's pretty much what you would expect in the competitive market. Everybody is forced to compete - or holding roughly constant to benefits. Everybody is forced to compete at about the same level.

Q Is - is a regression analysis an important tool to verify your assumptions and conclusions?

A Yes. It gives you a vigorous statistical analysis as opposed to some inferential.

Q In making your analysis, did you also look at wins and losses of business, particularly in Eastern Washington?

A We did.

Q And what did you find there?

A Because some of the win loss data is attorney eyes' only, I'm going to give just a piece of it here. We looked at - we wanted to know whether Premera was winning and losing business in Eastern Washington. And these data - these data show that Premera lost - in 2002 lost about 20,000 lives in the two categories, large group and small group. That's in the 14-county area where Asuris operates and Regence doesn't have the blue mark.

This next one comes from Form B data and it looks at some examples of groups that have increased their membership

in Eastern Washington. So we do find that there is - there is movement by the rivals in Eastern Washington to increase membership.

Q Okay. Now, you - you looked at premiums and - power over premiums. Did you also look at profits to test market power?

A We did. And profits are difficult to measure and economic profits are particularly difficult to measure, but what we wanted to do is look over time to see if there was any - remember, market power is the exercise that has to be increased in price so it has got to be profitable and sustained.

Did we see any of that pattern in Washington? And the answer is these are the underwriting margins for these groups over this period of time, '97 to 2002. And what you saw pop out there is the red ink. There is an awful lot of loss that these companies have suffered. There is no - there are no substantial profits being made here. And what this chart tells you is simply that Washington is a very difficult state for a health insurer.

Q Does that basically conclude your analysis, your look at the selling side in competitiveness?

A Yes, it does.

Q Are you ready to move on to the buying side?

A Certainly.

Q When you address the buying side, did you look first at the market definition of - with respect to the purchase of providing services?
A I did.
Q And what did you find there?
A Well, the controversies on the buying side is a lot more about the geographic market, which is how big is the area that we - that an insurance company buys and its provider services - contracts essentially for its provider services.

So we looked at a number of different areas. The OIC's consultants have chosen to look at county levels. We have looked at counties. It is certainly larger than a county. We have look at metropolitan statistical areas. We have looked at something called health service areas, which are a construction of Medicare - the Medicare flows and - we - but we believe it could be as large as Western Washington and Eastern Washington. Because many of the insurers might decide when they go to set up a provider network that they are not just going to set one up in the Tri-Cities area or just in Spokane, they may enter the whole of Eastern Washington.

But I guess more importantly, since Western Washington is considered to be a - a competitive provider market, we are going to look at Western Washington versus Eastern Washington, just as the OIC's consultants have done, to see

if we find any differences in what those two markets look like.

Q And do all consultants essentially agree, then, that Western Washington is competitive?

A Yes.

Q Okay. Now, in analyzing the competitive market for provider services in Eastern Washington, how did you go about that?

A Well, let me start by just saying that Eastern Washington, there are two sorts of areas we will discuss. Eastern Washington is, you know, basically those counties east of the Cascades. It is a 20-county area that is shown here in green. But also we will - because of the slight difference of where Asuris operates - that is Regence without its blue mark operates - we may also talk about a 14-county area. And this hashed green area is that 14-county area.

Q Any significance in the fact that Eastern Washington is green and Western Washington is kind of a sandy color?

A I suppose the rainfall would reverse that normally, but I just thought the green looked good.

Q Okay. Now, did you look at the market structure - the market share on the buying side?

A I did.

Q And what did you find there?

A We - we wanted to estimate the share of the total buying that Premera does in the area of greatest interest, Eastern

Washington. It is not - it is not a very easy thing to do because as I think probably most of us know, PPO data are hard to come by, but particularly self-insured data are hard to come by.

So if you say to yourself, to whom can doctors and hospitals sell their services, how much - how much of those patients are really covered by Premera? An approximation of that is to look at the insured population and what share Premera has of that insured population. So you can see we have taken the total population in the 20-county area, subtracted off the uninsured from Washington State population data, subtracted off those covered by the military, we get the insured population.

And then we looked at - we looked at Premera's both fully-funded and self-insured, an estimate that we made, and we estimate that Premera is responsible for 32 percent of the patients that providers could see in Eastern Washington.

Q Did that estimated share give you any concern about market power on behalf of Premera in Eastern Washington?

A No, particularly since it obviously can be challenged from any time from the sale of insurance side.

Q Now, did you also look at the entry and growth of the number of physicians in Eastern Washington?

A Yes.

Q What did you find there?

A Well, as an indicia you would think that - if reimbursements are so low that input usage is falling and that people are being driven from the market, you would think that the number of physicians per capita would fall. You can see from this chart covering '94 to 2002 that these are active, nonfederal patient care physicians and they - they have increased over time.

Now, there are some counties that have bounced up and down. And I'm sure there are anecdotal people who are leaving certain counties, but with respect to the whole area, the Eastern Washington area, the AMA data tells us that physician population ratios have increased over time.

Q So that's good news for the patients and it is good news for competition?

A In addition --

MR. COOPERSMITH: I will object.

JUDGE FINKLE: Sustained.

MR. COOPERSMITH: Thank you.

MR. TAUSEND: I'll withdraw the question.

Now, the next slide is one of the statistical analyses that you performed and that's the slide that has confidential competitor information. So, at this point, we need to ask to have the room closed off for --

JUDGE FINKLE: Is it a couple things?

MR. COOPERSMITH: Your Honor, is it possible to --

JUDGE FINKLE: Yeah.

MR. COOPERSMITH: I think we are heading there.

JUDGE FINKLE: We are at about a break time, number one. Number two, are there going to be other questions of this witness on direct that are not going to require showing confidential materials?

MR. TAUSEND: Yes, there are.

JUDGE FINKLE: Can you pass this area and return to it?

What we have tried to do is confine closing the room, including the cross on those subjects, to one segment of examination.

MR. TAUSEND: This is the only one, Your Honor. And we can do that or we could do it now, then take the break and reopen the room. Whatever.

JUDGE FINKLE: Let me ask other counsel whether there are confidential areas expected in your examination.

MR. ELLIS: I don't anticipate there will be on behalf of the OIC, Your Honor, but depending on the nature of the confidential information we are about to look at --

MR. COOPERSMITH: Same response from the Intervenors, Your Honor.

JUDGE FINKLE: Sure. Well, about how long would you need to take on this matter?

MR. TAUSEND: Not five minutes, probably not three.

THE WITNESS: If I may offer a suggestion, maybe I could describe it generally since we all have a picture of it, but just skip over it.

MR. TAUSEND: That would be fine.

JUDGE FINKLE: And if you are able - the option is to not show that particular slide projected - or since we have got a copy, to cut off the monitor. You may be able to handle it. If you can't, we will close the hearing. I would like you to try, though.

THE WITNESS: Turn that monitor off, though.

JUDGE FINKLE: So maybe if the monitor can be turned off and then we will take a break as soon as you finish that area.

MR. TAUSEND: That would be fine.

Q (BY MR. TAUSEND) Dr. McCarthy, did you do any statistical analysis on the buyers side?

A Yes, we did.

Q And can you describe the conclusions of what you did and what the nature of them is without slowing the slide?

A Right. Again, what we wanted to do is look for actually effects - in this case, actual buyer market power. So the slide generally I'm going to - the slide that others have in front of them was to simply compare what Premera reimbursed relative to Medicare.

Medicare, as you may know, offers a standard rate and it

varies by geography. So what we did was to look over various areas, Western Washington urban, Western Washington rural, King County, of course, Seattle, Eastern Washington urban and Eastern Washington rural. We wanted to see how Premera's reimbursements compared east and west.

And what you see there, without describing the numbers, is that the rates in Eastern Washington are not significantly lower than those in Western Washington. That was confirmed statistically as well as by this picture.

Q Now, did you do a second statistical analysis on that?

MR. TAUSEND: We can turn the monitor back on. And then right after this, Your Honor, we will switch to the access question so that would be a good time, if you wish, to a take a break.

JUDGE FINKLE: Right. As soon as we are at a convenient breaking place, we will take a break.

Q (BY MR. TAUSEND) Tom, are you on the next slide?

A I am.

Q That's the second statistical analysis?

A Yes. This is another regression analysis. I won't go through the whole part of regression. It is very similar to a regression analysis that Dr. Leffler did on behalf of the OIC staff and the AG's office. But we have used allowed amounts per claim.

In other words, this is amount, if you contract - if a

physician or hospital contracts, there is an allowed amount under that contract. It is the sum of what the insurance company promises to pay you, plus what you collect from the patient in terms of the copay, you know, the $10 copay for the office visit, for instance.

So we looked at the allowed amount per claim that a physician submits. And, as you can see, we have held constant here how much work was done during the claim, that is - the RVU stand for relevant value units. It is the measure of the output that, let's say, the physician did.

And, again, we ran a regression to see whether in Eastern Washington the allowed amounts per claim were significantly lower or higher than in Western Washington, using Western Washington as the benchmark because everybody agrees that it is competitive.

And what we found, as you can see in the bubble to the right, there were rates in Eastern Washington that were not significantly lower than in Western Washington. That would have to be a negative number greater than two and it is not.

Q Could you summarize, then, your conclusion as to Premera's market power on the buying side in Eastern Washington?

A In our analyses, both our market structure analysis and our analysis of these direct effects, we don't find any evidence for significantly lower pricing, reimbursements in Eastern Washington, especially when you hold constant the specialty,

the number of - the type of work done, et cetera. The - the numbers show that rates are very similar.

JUDGE FINKLE: Okay. Let's take a 15-minute break.

(Brief recess.)

JUDGE FINKLE: I have been asked to announce that in case some of you don't know that the lunchroom across the hall is now open. You don't need to leave the building. It is the grand opening.

MR. TAUSEND: Thank you.

JUDGE FINKLE: So please continue.

THE WITNESS: Excuse me. Could you turn on the monitor?

Thank you.

Q (BY MR. TAUSEND) Now, the second question you addressed, Dr. McCarthy, is related to the effect of the conversion on consumer access to healthcare products, health insurance products and providers.

In addressing that, how did you go about assessing that question?

A Well, we looked at four factors to see whether there was any reason to believe that access would be reduced.

Q Okay. Should we discuss them one at a time?

A Please.

Q What was the first factor you focused on?
A The first one had to do with Premera's focus on financial viability. The argument, of course, that has been made in some of the various testimonies that the worry is that Premera's incentives will change, therefore it will focus on its financial bottom line.

We wanted to examine whether they are not already focusing on their bottom line as a not-for-profit simply because of the competitive nature of the market, they have no choice to do that.

So we looked at the factors involved in their financial viability. The first is - and we heard some of this from Ms. Novak this morning - Premera is in a weak surplus or reserve position and they have to protect that position already.

So that's very important from a competitive point of view because if they had market power, even as a not-for-profit and just weren't exercising it, they wouldn't be in that surplus problem position. They would use - even if they were the most noble of not-for-profits, they would - they would use their market power to at least give themselves a stable and comfortable level of surplus. And they have not been able to do that. That is an important measure that the competition has been finding.

Secondly, they have been forced to pull out of various

products, Medicare HMO for instance, as a result of the nonfinancial viability of those products. And that has also involved cutting back certain geographic areas where they serve some of those lines of business. So it is pretty clear they have had to focus on their financial viability.

Q What kind of operational constraints has Premera faced?

A Well, we - this - again, talking about access, we want to know whether there is any - there are any operational constraints that would cause Premera to not want to reduce access and, therefore, we could predict that they wouldn't produce access.

The first, and probably most important one, that gets talked about a lot is their stable provider network. It is an important competitive strength for them, allows them to work with multisite employers.

Q Is that a significant factor in the State of Washington?

A Yes, it is. It's the - Washington, as you know, has densely populated areas and sparsely populated areas. And a statewide provider network - there are a few that are close to statewide providers - provider networks, but it's competitive strength for them to be able to offer it.

A related issue really - Premera - it is possible that if they were to leave a county and decide not to serve it, that they could be accused of abandoning that county if another Blue Cross or Blue Shield plan wanted to serve that

county and they would be in jeopardy of possibly losing their rights in that county. So that's another reason to stay there.

Also the HIIPA - the one we mostly hear about is patient privacy. HIIPA has within it a provision that you can't leave a line of business and reenter for five years. This, to me, is actually a very important measure of this supply response. If you ask yourself why would HIIPA put a regulation in like this, it is because they don't want companies hitting and running is what the economists generally call it; entering a market, setting up, getting accounts and then leaving just because it wasn't as profitable as they thought.

Q So what does it tell you, then, about entry as an additional point?

A That it is easy with very little sunk costs.

Q Did you also explore the impact of previous conversions?

A Yes, we did.

Q And how did you go about that?

A Well, we - we looked for studies. The - the two that we think offer the most insight because they are based on some rigor of analysis, either rigorous interviews or statistical analysis, were first the economic study done in the CareFirst conversion. That conversion, to remind us, is the Maryland/Washington D.C. area conversion. And we looked at

the results of that statistical analysis.

These economists were retained by the Maryland Insurance Authority. First, they found that premiums decreased slightly after the conversion. Secondly, they found that provider reimbursements remained basically the same.

This is a study, as you can see in the footnote - though you can't read it probably from very far in the back - a study by Roger Feldman, Doug Wholey and Robert Town.

The second - besides the Feldman study, there was another study done by Mark Hall and Chris Conover, the Hall and Conover study. They were consultants to the North Carolina Insurance Authorities as well. They conducted interviews about the effects of conversion after an - and interviewing people in the various states that were involved in four conversions.

And based on those interviews, they found that most of their interviews felt there was little change in the plan's behavior. With - the regulatory and the commercial environment really dictated how the companies behaved after the conversion.

And secondly, a quote from a press release of theirs, "The conversions don't have a strong or consistent negative effect on affordability or accessibility."

MR. TAUSEND: Your Honor, we propose to offer these two reports as materials that the witness has relied on.

The Feldman Wholey is Premera 26 and the Milbank Quarterly, which is the Hall and Conover, is Premera 28. So we offer them at this time.

MR. ELLIS: No objection.

MR. COOPERSMITH: No objection, Your Honor.

JUDGE FINKLE: Admitted.

Q (BY MR. TAUSEND) What were the four states in the Hall and Conover North Carolina study?

A Virginia, the Trigon conversion, Georgia, Missouri and the granddaddy of them all, WellPoint in California.

Q Did you do any statistical analysis on the question of access?

A Yes, we did.

Q And what did you do there?

A Again, we took the same regression model, the premium model that I described earlier, and in this case we wanted to ask the question is there any reason - is - do not-for-profits charge premiums that are higher or lower. That is, is there a difference between the for-profit competitors in this state and the not-for-profit competitors in this state?

And what we found was that - you can see in the last variable here - is the not-for-profit variable and that shows that the not-for-profits have behaved no differently than the for-profits in the State of Washington. And, again, an indicia of competition among the not-for-profits

and for-profits because both are here.

Q Who would you say are the competitors that Premera has to be concerned about in it business operations and its business successes in Washington?

A Well, there are sort of two levels in that answer. One is currently and the other is in the future. Currently, there - of course, there are - Regence and Group Health are large competitors, but we know PacifiCare - and we talk about various parts of the state - PacifiCare, Aetna.

There is one document that the Intervenors put in that showed Aetna having an estimated 500,000 lives, 500,000 members across the state. That's higher than I would have estimated, but it was in one of their documents.

So - and you have Health Net has just come into the state in a probing way. United is in the state. And if we talk about the future, one that I would be looking over my shoulder for is United. They are a very well-run company. They have been buying - they have been acquiring assets in Maryland and in - they are seeking to buy Oxford - the Oxford Health Plan around the New York City area.

United is very well-run, very well-financed and has a lot of cash. And it wouldn't surprise me if for anytime they find a market opportunity, it would be "Katy, bar the door," because they would come into the state.

I think however - I want to be clear that we looked at

the profit rates. This is not a state that is really attractive to - to profit opportunities because there is no monopoly problem. There is no excess profitability, so it is simply a tough state.

Q All right. Can you tell us whether the nonprofitability, nonattractiveness economically of this state applies to not-for-profits as well as to for-profits?

A Sure. I would think that not-for-profits have to raise capital, too. Not-for-profits have to grow. Not-for-profits have to change their technology. It is exactly the debate that you have heard up to this point as to what is the best way to get a hold of that capital. So everyone is faced with the same competitive constraints.

Q And am I right that when you turn to talking about the future, those specific companies that you mentioned - there were about five or six of them - are for-profit companies?

A Oh, yeah. The interview notes that have been part of the record indicate that Aetna and PacifiCare are looking into Eastern Washington. Aetna is already there. PacifiCare has supposedly moved into Eastern Washington. I don't know which product they are beginning to offer, but they are in this state and will expand when they see the opportunity to do so.

Q Did you reach an opinion as to whether or not the conversion will change the behavior of Premera given investor pressures

and incentives?

A The answer is yes. It - even if you were to argue that somehow their incentives were different - it is some sort of philosophical argument about incentives - the answer is it cannot change their behavior. It is a competitive market. It is a competitive market with competitive constraints. And whether they are not-for-profit or for-profit, those competitive constraints will dictate its behavior, not incentives of investors or not having investors.

Q Dr. McCarthy, could you at this point then, summarize your conclusions on the two questions you were asked, competitiveness and access?

A Yes. We concluded, based on that analysis that I have shown you and a lot more, that the proposed conversion is not likely to substantially lessen competition. First, as I have described, we find the markets to be characterized by competition, and probably even most importantly - we haven't talked much about this - there is no reason to believe the conversion is going to change this market structure. There is nothing about the conversion that should change these conditions.

So we feel that the health insurance market premiums will not increase and in the provider services markets, as a buyer or a contractor reimbursement, rates will not decrease.

Q And on the question of consumer access?
A We conclude from our analysis that the proposed conversion is not going to reduce consumer access. Again, competition has forced Premera and really others in the state to focus on their financial viability.

The conversion, again, isn't going to change that because these are competitive pressures. And therefore Premera, whether for-profit or not-for-profit, is going to have to offer just those products and in those geographic areas that make commercial sense because it has to focus on its financial viability.

Q Thank you.

MR. TAUSEND: At this point, Your Honor, I would like to offer a couple more exhibits. Premera 22 is the NERA report. Premera 23 is the NERA errata sheet to that report. Premera 24 is the supplemental NERA report. So we offer those at this time.

MR. ELLIS: No objection.

MR. COOPERSMITH: No objection, Your Honor.

JUDGE FINKLE: Admitted.

MR. TAUSEND: And lastly, for what I would hope is the convenience of the Commissioner, we would offer Premera 35, which are the packet of slides that Mr. McCarthy has used in his presentation.

MR. ELLIS: Well, we have several problems with

that, Your Honor. Number one, I believe that P-35 includes a number of slides that have not been presented today and as to which we have had no testimony.

And, in addition, I had understood prior to the beginning of Dr. McCarthy's testimony that the slides that have been presented and have been used were being used purely for illustrative purposes and were not going to be offered as an exhibit. And, accordingly, I have gone to sleep slightly on whether or not the proper foundation has been laid for each of these slides. And I certainly don't suggest that we go through them slide by slide, but I simply have to object at this time to them being offered as evidence.

JUDGE FINKLE: Before you respond I want to see if there is any further comment.

MR. COOPERSMITH: Nothing further from the Intervenors.

MR. TAUSEND: Yes, Your Honor. With respect to the offering of the exhibit, we would be happy to substitute for P-35 the packet which both sides have of the exhibits that were actually used in the presentation and not any others and - and only one of them wasn't shown, but everybody has seen that one and that was the one that is actually numbered at the bottom 22, the regression analysis.

And in terms of - I did at one point tell Mr. Ellis that

they were for demonstrative purposes, of which they are, but I think they reflect the testimony of the witness. You were able to see them on the board and I think they simply are a summary of what he testified and so we offer them on the thought that they could be helpful to everybody in this proceeding.

JUDGE FINKLE: Anything further?

MR. ELLIS: Nothing further.

JUDGE FINKLE: I will not admit the exhibit. Of course, the Commissioner and I do have copies of the slides and if we need to refer to them in assisting and understanding the testimony or refreshing our recollection - the Commissioner in particular - obviously we will do so, but I don't think it is appropriate to admit a summary in fact of testimony.

MR. TAUSEND: Thank you.

JUDGE FINKLE: Does that complete --

MR. TAUSEND: That completes the direct testimony of Dr. McCarthy.

MR. ELLIS: Mr. Commissioner, Judge Finkle, I'm Special Assistant Attorney General John Ellis. And since this is my first appearance in this proceeding, I thought I should introduce myself. I will be asking questions of Dr. McCarthy on behalf of the OIC staff .

CROSS-EXAMINATION

BY MR. ELLIS:

Q And good morning, Dr. McCarthy.

A Good morning, Mr. Ellis.

Q I want to begin by focusing on what you characterized as the selling side of Premera's business. That's the side of selling insurance in competition with other carriers in the state as opposed to the part of its business in buying provider services; is that right?

A Yes, fine. We can start there.

Q And your - one of your bottom line conclusions is that the Commissioner should not be concerned about Premera increasing premiums because, most importantly, it lacks market power; is that right?

A That's correct.

Q And that conclusion hinges to a great extent upon your definition of the relevant market, doesn't it?

A I don't think it does, but I think they are consistent with it, but I don't think it hinges on that. As I tried to suggest, market share and the definition of the relevant market are not as important as the competitive process that gets you to a competitive outcome, but I don't want to say they are not connected either.

Q And you rely also very heavily on your supply side analysis as well as recognizing the demand side analysis that is

generally used in analyzing these transactions, don't you?
A Well, I disagree that it is generally used. I mean, generally used, do you start there? Yes, I agree with that. But - and I do take it to supply side responses and that is part of my testimony and I rely on that, yes.
Q And when you say that you - that the demand side analysis is a starting point, it is generally used as a starting point; do I have your testimony correct there?
A Yeah, I think that's right.
Q And under your definition of the relevant market on the selling side, there is no separate Eastern Washington market, is there?
A On the selling side, correct.
Q The market includes the entire state including both Eastern Washington and Western Washington?
A Because of those supply side responses, yes.
Q And in your definition of the relevant market, you have included all health insurance products and lines of business; that's correct, isn't it?
A Yes, but, again, I - for the brevity of the slide, I just want to point out distributed by - distributed or sold by commercial insurers. I'm not - for instance, Medicaid - the traditional Medicaid in this state or traditional Medicare is not in that relevant market. And all health insurance would sound like it is, so that's why I qualified it when I

put the slide up.
Q So those are the only two products or lines of business that are not included in your definition of the product market; is that correct?
A Probably not. I think there are usually some county programs and some indigent care programs that are beyond that, but I'm talking about - rather than split hairs, I'm talking about publicly financed products like Medicare HMO, which is now called Medicare Advantage.

Medicare HMO is, or at least was, offered by commercial carriers and they competed to sell that. So that's publicly financed, but it is not publicly delivered and that's the distinction I'm making, anything distributed or delivered or sold by commercial entities, even if it is on behalf of government entities like the State of Washington or the federal government.
Q So you do include all of the - what you have referred to in other contexts as the public lines, including nontraditional Medicare, nontraditional Medicaid and the Basic Health Plan, in the same product market as the other commercial lines and products; correct?
A I think I agree all the way up to the Basic Health Plan. That is distributed and sold by commercial competitors.
Q And so that is included in the product market or not?
A Yes, it is.

Q It is?

And so when you look at the companies that are involved in the relevant market, you have included companies that sell more commercial products than public products such as Premera or Regence, don't you?

A They are mixed, yes.

Q And the other side of that coin is you also include a company like Molina, don't you?

A Yes, and Community Health would be similar to Molina.

Q And those two companies don't sell any commercial products in the normal sense of the word, do they?

A Taking the normal sense of the world - word to mean large group, small group, individual, I think that's what you mean by commercial in that context. They are a commercial company. They are a for-profit company and they - so they are a commercial entity. But if you are talking about the lines of business meaning only large, small and individual, then yes, they do not sell that.

However, when they bought QualMed, which is how Molina came into this state, QualMed did sell both Medicaid HMO and commercial business. They simply chose to specialize in Medicaid HMO.

Q And they did not continue to carry the QualMed commercial contracts, did they?

A They did not.

Q And both Molina and Community Health Plan specialize in this state and elsewhere in low-income programs, don't they?
A That's right. Medicaid Managed Care for the most part.
Q So, in essence, your definition of the relevant market includes essentially every insurer in the state, doesn't it?
A Other than state directly-funded or federal-funded, yeah. But, again, supply substitution, it tells you that Molina has a significant - whether it is Eastern or Washington Western Washington of the state, Molina has a significant network.

If Molina found that it was profitable to come into the individual business - which is a tough business - it is a for-profit company, it would look at its plan and it would consider coming into it. And I think as I told you during my deposition, I don't pick them as the leading candidate, but they are a for-profit company with access to capital who could do it.

Q I can't remember now whether that answer should be interpreted by the Commissioner as a yes to my question or a no.

Have you included essentially every carrier in the state in your definition of the company's participating in the relevant market?

A I think I said yes at the beginning of my question.
Q Good. Thank you.

You have included Premera obviously, which, for example has many members in Eastern Washington; is that correct?
A Yes, they do.
Q And you have included insurers that essentially have done no business in Eastern Washington at all, haven't you?
A I would have to look at the list. I think there are some, but there are some that have been in and out of Eastern Washington as well.
Q Well, let's take Kaiser, for example. Do you know where Kaiser does business in this state?
A They are in the Portland area, the Clark County area.
Q They sell primarily in Clark County?
A That's correct.
Q Operating out of Portland?
A That's right.
Q And you have included them in the relevant market that includes Eastern Washington as well as Western Washington?
A Again, you don't have to serve Eastern Washington to be in the relevant market.
Q So is that - that's a yes?
A I have included Kaiser, yes.
Q Yes. Thank you.
And I take it from your presentation, your testimony this morning, that the size of the company is not a particularly important factor or not an important factor at

all in your determination as to whether or not they participate in the relevant market?

A What do you mean by "size"?

Q Number of members served.

A What - how would I interpret Aetna in that respect? Aetna may have a small presence in Eastern Washington at some point, but yet it is a huge company. Are they a small company or large company in your question?

Q Let's get back to the question that I asked. Does the size of the company in terms of its membership make a difference in your analysis as to whether they should be considered part of the relevant market?

A Usually not. It might make a difference as to who is the most likely entrant - most likely expander or entrant.

Q So we have large companies with large membership and companies with small membership all grouped together in the same relevant market?

A Yes. We have, for instance, United Healthcare listed in that market. They handle group - large group mostly. They have the Hanford contract, 20,000 members or so. They are small at this moment, but they are a competitive force in this state, even when they are small, because of the response that I think you would get if there was a monopolization attempt anywhere in the state, that is they would expand.

Q In your slides that you used this morning, Slide Number 13 you indicate at the bottom line - that is the slide that indicated that Premera had lost membership between 2001 and 2002 in Eastern Washington, but you still show that at the end of 2002 they had more than 200,000 members in Eastern Washington; is that correct?

A That is correct.

Q At various times in your testimony and reports you pointed to Asuris as an example of a company that needs to be focused on in looking at the competitive situation in Eastern Washington, haven't you?

A Sure. On the next slide that you used, Page 14 of your slides, you show that Asuris at the end of 2002 had slightly under 14,000 members in Eastern Washington; is that correct?

MR. TAUSEND: Your Honor, it would be helpful if we could have the slide back up for this examination.

JUDGE FINKLE: Sure.

MR. ELLIS: If we could show Slide 14.

THE WITNESS: Whoops. Excuse me.

MR. ELLIS: That's the one.

Q (BY MR. ELLIS) And looking at Asuris Northwest you show 13,874 members in Eastern Washington at the end of 2002, don't you?

A Only for small group.

Q For small group?

A That's just for small group.
Q Do you know how many large group members they added that time?
A I think the estimate is - I don't know at the end of 2002, but the estimate now is more like 29,000 at the end of 2003. I don't know what it was at the end of 2002.
Q 29,000 in large group?
A No, total members.
Q Total members?
A I don't know the amount in 2002 of large group membership.
Q So Premera had about 207,000, Asuris had something around 29,000 members based on your recollection; is that right?
A And adding products and growing, yes.
Q Now, one of your charts this morning in looking at different supply side responses referred to the possibility of Humana entering the State of Washington.

What is Humana, for those of us that aren't familiar with products in the rest of the country?
A Humana is a for-profit, large, multistate - I think some would consider national in that respect - they are not in every state obviously, but multistate seller of healthcare coverage.
Q And you indicated that they don't do much business in Washington, to your knowledge; that is correct?
A To my knowledge. They may have - they may have national

contracts for which they have subcontracted to a provider network - a rental network to get that coverage for a national contract, but I don't know specifically of their presence.

Q Do you know whether they have any plans to enter the State of Washington?

A I do not. I was using it only as an example.

Q Would it be difficult for Humana to enter into the State of Washington market if it felt that it was profitable to do so?

A No, it would not be difficult.

Q Would it be anymore difficult for Humana to enter the state than it would be for a Western Washington carrier to expand into Eastern Washington?

A I think it would be more involved. It would be more costs into coming into the state than to expand, but I don't think either of them are substantial barriers to entry by any stretch.

Q Well, if that's true, why didn't you include Humana as one of the companies that should be included in the relevant market?

A Well, there is an argument - and it has been found by at least two antitrust courts - that it is a national market for health insurance. In the Ball Memorial (phonetic) case and in the U.S. Healthcare versus Health Source, I think is

the name of the other case, where they found more than a statewide market. So there is an argument to be made that Humana could come into the market if a profitable opportunity presented itself.

Q So why didn't you include Humana in your calculation of the market shares of the Washington companies?

A Because I felt that the - we - in our work we have done it as the state regulatory structure may be somewhat different and that there is a conscious decision to come into a particular state and get licensure in that state. And that's a breakpoint between - between just potential entry and entry. Who is already in the market is what I mean by having already entered.

Q But it is entirely consistent with your supply side analysis, isn't it? It would be consistent to include Humana in the calculation of market shares for the Washington relevant market?

A It has mostly to do with likelihood and probability. And the answer is yes, it would be. It would be consistent to put it in there, but the - the - I would say a couple of things. One, you don't need to. There are plenty of supply substitutes and existing competitors already in the state.

Secondly, because you would be applying for licenses, setting up shop and building provider networks or renting them, it is another threshold to actually enter the state.

And that's where I have chosen to draw the line.
Q But it's not a difficult threshold?
A I don't think it is a terribly difficult - if there were a monopolization attempt where market prices were high and profits were being made, I don't think it would ever get to Humana having to consider coming into the state, but that certainly would be an attractive opportunity for a company like Humana.
Q And if you took that approach, how would you decide whether there are any significant health carriers in other parts of the country who would not - who should not be included in the Washington market?
A Well, I think there are ways to rule some people out, but this is not - this doesn't have to be taken to - there is a limiting principle here. It doesn't have to be taken to an illogical extreme. The Albuquerque system called Presbyterian Health Plan, it is a provider-based system, it is very unlikely to come up to Washington because it is a provider-based health plan. So you can make certain distinctions.

Humana is not a provider-based health plan. Humana is in a lot of states. Humana would consider profitable opportunities. Washington State is a tough state for being a health insurer and I don't think it is on Humana's radar screen. And obviously that is pure speculation.

Q And how many other insurers are there that are not doing business in Washington that would be in the same position as Humana?
A I don't know. I would have to take an inventory.
Q There would be a lot, wouldn't there?
A There would be - well, there are - there are many of them that are here, the national carriers, many of them are here. CIGNA is here. Aetna is here. United is here. PacifiCare is here. Health Net just entered. Those are the regional or national players. We don't have some of the east coast plans here, of course.
Q I think my question was directed to insurers that are not here.
A Well, I'm saying most of the national players are here.
Q So you are saying there are very few national players that are not here that could enter the market like Humana?
A I don't know. I would have to look at the whole list. These are off the top of my head as to who some of the other large players are.
Q What about WellPoint?
A WellPoint could come in with its Unicare - well, WellPoint - I guess we have to talk about this as transitional. WellPoint has been approved by the federal - the federal antitrust authorities - I forget whether it is DOJ or the FTC - to be purchased by Anthem. So shortly there will be

no WellPoint, it will be Anthem.
Q What about Anthem?
A Could Anthem come in? Anthem could come in with an unbranded product.
Q And if you were calculating market shares based on the market that included a company like Humana or Anthem, how would you attribute a market share to them in a Washington relevant market?
A Well, first of all, if - if - if you wanted to make that leap - I have not made that leap and you can push that leap if you like - but if you want to make that leap, you would make it - it would have to be a national market. And you have to decide - it wouldn't be a Washington market anymore because you are considering outside providers.

And so you would have to count their share - their ability to come in and compete, the capacity of that company. And it would be a meaningless exercise. The market - besides, remember what I said earlier, market share is really not the proper focus. The proper focus here is the competitive process. There is nothing blocking that competitive process.

Premera can have a large share in Eastern Washington. There is nothing that Premera has done as an anticompetitive bad act to create a barrier to entry or to drive people out. It is a wide-open market for anybody that wants to come in.

They don't have exclusive contracts. They don't have predatory pricing. They don't have any of these, sort of, antitrust bad acts that would argue that their share in Eastern Washington is due to anything other than being a successful company.

Q If I can go back and extract the answer to my question from that, are you saying there would be a way to impute a market share to Humana if you are going to treat them as a participant in the Washington market?

A Nobody would bother, that I know of.

Q And what you refer - you alluded to bad acts. The possession of market power or monopoly power, that doesn't necessarily imply any bad acts, does it?

A It doesn't have to, no.

Q And there are no alleged bad acts involved in this proceeding, are there?

A No. The point I'm making, though, is whether there is any sort of barrier to entry that has been created by any conduct of Premera.

Q But --

A That's what helps us to analyze those supply responses.

Q The possession of a barrier to entry doesn't imply a bad act, does it, necessarily?

A It depends on the source of the barrier.

Q Dr. Leffler concluded, did he not, that Premera's possession

of the Blue Cross/Blue Shield trademark resulted in something of a barrier to entry. That's not a --

MR. TAUSEND: I object to the form of the question based on testimony not in evidence and not accurate.

MR. ELLIS: It is based on the report that has been filed in the case, which I believe Dr. McCarthy has read and is thoroughly familiar with.

JUDGE FINKLE: Have you read that before?

THE WITNESS: I have, sir.

JUDGE FINKLE: Go ahead and answer, please.

A It is an easy answer. I also attended Dr. Leffler's deposition in which he said it was not a barrier to entry.

Q (BY MR. ELLIS) Let's assume that it were a barrier to entry, no one would say that was a bad act, would they?

A No.

Q Good.

A It is - it is an investment that has been made over a long period of time.

Q Now, Dr. McCarthy, I'm going to hand you --

MR. ELLIS: If I may approach the witness?

JUDGE FINKLE: Yes.

Q (BY MR. ELLIS) -- pages from Premera's Exhibit P-96, which are the Department of Justice and Federal Trade Commission Horizontal Merger Guidelines.

MR. ELLIS: I have made copies of the cover page,

plus Pages 6 through 10, that cover a section of the Guidelines that I would like to ask Dr. McCarthy about.

Q (BY MR. ELLIS) Dr. McCarthy, you are familiar with the DOJ FTC Horizontal Merger Guidelines, are you not?

A Yes, I am.

Q These guideline are used by the DOJ and FTC to determine whether a merger or acquisition may lessen competition, aren't they?

A Yes, they are used in a merger context.

Q And many state attorneys general use them for the same purpose, don't they?

A They have some differences, but, yes, the same basic approach.

Q And among other things, the Guidelines include an analytical framework for determining a relevant market, don't they?

A Yes.

Q I would like to direct your attention to the first two sentences of the second paragraph on Page 7 --

MR. TAUSEND: Your Honor - oh, finish your question.

Q (BY MR. ELLIS) -- the paragraph that begins, "Market definition focuses solely on demand substitution."

MR. TAUSEND: Your Honor, I would to ask Dr. McCarthy if he considers this a sufficiently complete excerpt from the Merger Guidelines to be able to answer questions that are going to be asked him.

JUDGE FINKLE: Well, if he needs to refer to other materials, I will certainly give him that opportunity, but I'll allow the question for now.

A I'm sorry. What was the question about those paragraphs?

Q I was simply directing your attention to those paragraphs.

MR. ELLIS: Let me say, Judge Finkle, with regard to the implicit question of completeness that Mr. Tausend raised, the section that I am interested in asking Dr. McCarthy about from the Guidelines is Section 1.0, which is the general overview of "Market Definition, Measurement and Concentration."

And I don't have questions about other sections and I would hope that Mr. McCarthy will not need to refer to the full exhibit in order to respond to my questions, at least.

JUDGE FINKLE: We will see. Go ahead.

Q (BY MR. ELLIS) Let me read into the record the first two sentences of the paragraph that I directed your attention to, Dr. McCarthy.

That paragraph begins, "Market definition focuses solely on demand substitution factors, i.e., possible consumer responses. Supply substitution factors, i.e., possible production responses, are considered elsewhere in the guidelines in the identification of firms that participate in the relevant market and the analysis of entry."

Did I read that correctly?

A Yes - excuse me - yes, you did.
Q So it is true that under the Guidelines in defining the relevant market you are directed to look directly solely at demand substitution factors, not supply substitution factors; is that correct?
A Not really. It is true that it focuses solely on demand substitution, but that's not the way the Guidelines are used and that's not the way that the FTC or DOJ goes about defining market.
Q It --
A They start there, they work through this process, but they do not come to the conclusion based strictly on demand substitution in most health - most healthcare cases I have been involved with or presented to them.
Q Well, I think that's consistent with what I just read, isn't it, that in defining the relevant market you look solely to demand substitution factors but then in addressing participants in the market you turn to the supply substitution analysis that you have described in your testimony?
A You said in market definition.
Q Definition of the relevant market, that's correct.
A I agree with these first two sentences, if that's the sole extent of the question. But the point I'm trying to make is product market definition does not stop at demand

substitution even though that's implied in that sentence.
Q Isn't it more than implied in the sentence? Isn't that exactly what the sentence says?
A We can talk about what the sentence says or we can talk about the actual practice of defining markets by the FTC and the DOJ.
Q My question goes to exactly what the DOJ and FTC said when they wrote this document.
A And you read that accurately.
Q Thank you.
And the document elaborates on what it means by probable consumer responses when it is talking about demand substitution, doesn't it?
A I don't know if it does in this excerpt, but in general, that's right.
Q If you turn to Page 8, the paragraph at the top of the page, which I will read into the record. "Absent price discrimination, a relevant market is described by a product or group of products and a geographic area. In determining whether a hypothetical monopolist would be in a position to exercise market power, it is necessary to evaluate the likely demand responses of consumers to a price increase. A price increase could be made unprofitable by consumers either switching to other products or switching to the same product produced by firms at other locations. The nature

and magnitude of these two types of demand responses respectively determine the scope of the product market and of the geographic market."

Did I read that correctly?

A You did.

Q So to illustrate how these provisions work, let's assume that we have a hypothetical firm that is the only seller of small group health care insurance in Spokane. Will you accept that as a starting point?

A As a hypothetical, sure.

Q Well, the Guidelines tell us to assume that there is only one seller in the market at issue, in this case Spokane, don't they?

A Not really. If you - what they - if there is a product that you are interested in, you look at the firms that would have to be combined in a hypothetical cartel or monopoly situation to make up a monopoly. If that's what you mean, then I agree. You don't have to assume that there is one firm. It could be a combination of firms.

Q If you turn back to the paragraph in the middle of Page 7 that I previously read from and you continue past the portion that I read beginning after the cross-reference to the "See sections 1.3 and 3," the Guidelines state, "A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a

hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a small but significant and nontransitory increase in price, assuming the terms of sale of all other products are held constant."

Now, are you saying that under the Guidelines we are not to focus on the assumption that we have a hypothetical single seller in the market?

A No, I didn't say that.

Q All right. I'm sorry. I misunderstood what you are saying then.

A What I meant was that there can be - take two situations. One situation is that there is a single seller of small group insurance in Spokane and let's assume for the purposes of your hypothetical that that's a relevant demographic market. I don't believe it is, but there is one seller of small group. Then you have the convenience of saying that's a hypothetical monopolist in the product of small group health insurance.

The Guidelines would also allow you to say let's suppose there are three sellers of small group health insurance in Spokane. When we start the analysis, we assume that they act as one, just to test whether there is any substitute for small group health insurance. All I was trying to say is it

does not have to be a single firm even though hypothetically you start as if they behave as a monopolist. That was the only - I realize that's a technical nuance, but that's the only correction I was trying to add.

Q And let me add my own correction, when I asked you to assume that we are focusing on Spokane, I did not intend that to indicate that we are starting with the assumption that Spokane is a relevant market.

A Okay.

Q The purpose of this exercise is to determine what the relevant product market and what the relevant geographic market is, isn't it?

A That - of the market definition exercise, yes.

Q And we do that by focusing on the demand responses of a consumer of small group coverage under our hypothetical to an increase in price by the only seller of small group coverage in Spokane; is that correct?

A In your hypothetical, yes.

Q And we look, first of all, to see, okay, they will have to pay more for small group coverage from our hypothetical single seller, are there other products that they can purchase in order to avoid that price increase? We do that, don't we?

A That's one avenue to explore, yes.

Q And if there is another product that they can purchase, then

we know that we need to include that product in the definition of the product market, right?

A Yes.

Q And we also look to see, okay, there is only a single seller in Spokane, but what if our consumer can drive 10 miles and get the same quality healthcare so that we know they would probably switch to the other provider 10 miles away, that's the next consideration, isn't it?

A If you mean other insurer, provider of health insurance, yes.

Q Yeah, that's right.

And if, in fact, the consumer can do that, then we know that we have to include that location 10 miles away in our definition of the relevant geographic market, don't we?

A Not really. You have to include the provider of the insurance who serves that other location. Geographic market is a geographic area, but it is meant to encompass those firms that supply the product or service.

Q Does --

A You are looking - in the end, you are looking for the firms that could constrain price increases.

Q I understand that you are looking at the firms, but isn't the most important thing to look at the availability of the family doctor that your consumer wants to find?

A I thought we were talking about insurance.

Q We are, but when a consumer buys insurance, isn't there primary consideration in this day and age in HMOs and PPOs to be able to get access to physicians and other providers who they have confidence in?
A Ultimately that's what they would like to do with that insurance coverage, yes --
Q So --
A -- but --
Q So the insurance company at issue, as I think you once said, could be in New York, but if they offer a network in the Spokane area or 10 miles outside Spokane that the consumer is satisfied with, then the relevant consideration for our geographic market is where the healthcare is, not where the insurer is, isn't it?
A If you are only focusing on provider-network-based insurance, but there is indemnity insurance that allows you to go anywhere and it doesn't necessarily get tied to a particular provider network.
Q And how much - how many people buy indemnity insurance in this day and age?
A Well, traditional indemnity has shrunk to under 10 percent, probably maybe only five percent. Just to be clear, PPO is an indemnity product, it is not-for-profit, what we call traditional indemnity.
Q So if we had an insurer in New York that was offering a PPO

product that had a network 10 miles outside of Spokane, you are saying that we would include New York in our geographic market?

A No, you would include the - the question is - you don't want to lose track of the question. The question is who can constrain price increases by that hypothetical monopolist and the answer to your question is that insurer in New York is among those that can constrain the price increase of the hypothetical monopolist in Spokane.

Q So under the Guidelines, we would include New York as part of our relevant geographic market.

A That's not what I said. You are losing market definition for the ultimate question of the competitive process and who constrains pricing.

Q I'm just trying to demonstrate for the Commissioner how the Guidelines operate. And I think we are at the point where we can move on to consider in more real terms what the choices would be with regard to the product market and the geographic market that would flow from the predicament of our Spokane consumer whose small group premiums went up.

In terms of the product market, the consumer would not have many choices in switching products, would they?

A I assume someone who is employed by an employer who has only a small group and buying small group coverage?

Q That's right.

A There is a limited possibility of joining an association and providing - buying coverage a different way, but if the employer is only going to consider small group products, then - then as a demand phenomenon they are limited to small group products.

Q And they are not likely to try and get a job with a larger employer so they can have access to large group coverage, are they?

A They are - there is a lot more flexibility that people try. For instance, a married couple might decide if the price of small group insurance at their particular employment went up too much, they might shift to the spouse's coverage. That's one option. They might take an individual policy.

But for the purposes of your hypothetical, the - the - that flexibility is much more limited than looking to another small group carrier.

Q And it is reasonable to assume that they would not be able to switch to Medicare coverage, isn't it?

A It depends on how old they are.

Q Well, presumably if they were old enough to qualify for Medicare, wouldn't you have assumed they would have been on Medicare in the first place?

A Not necessarily, no.

Q Is it reasonable to assume --

A Not if they are still employed and they get a better policy

through their employer.
Q Is it reasonable to assume that they would not be able to switch to Medicaid coverage or to Basic Health Plan coverage?
A Usually not. Depends on the income level in that situation.
Q Thank you.
And looking at the geographic market side of the issue, here, too, the Spokane consumer's options are limited, aren't they?
A As to where they can - if you are talking about provider-based coverage --
Q Provider-based coverage.
A -- not firms who could also constrain the market that are not tied to a provider base, then they would have to look at somebody who provided - who knows, maybe it is the west side of Spokane, maybe it is the east side of Spokane.
Q But it is not likely to be Walla Walla, is it?
A I have - I have - Dr. Gollhofer and I were discussing the other night some of his patients and some of them come up actually from the Tri-Cities area.
Q And I missed Dr. Gollhofer's testimony. Is Dr. Gollhofer a primary care physician or is he involved in a secondary or a tertiary care in his practice?
A He is an OB/GYN. I don't think too many are going to want to drive that distance to deliver their baby. He can still

have patients however.
Q It is certainly in the area of primary care. You wouldn't expect people to drive that kind of distance to see the family doctor, would you?
A Usually not, but all sorts of things happen.
Q And you certainly wouldn't expect them to be driving from Spokane to Seattle for primary care, would you?
A It would be unlikely.
Q Or to Clark County?
A I think that would be unlikely. I think convenience dictates we try to find providers who are close to our home.
Q So they probably aren't going to get replacement coverage from Kaiser?
A I didn't argue that.
Q It probably isn't going to do them much good to call Humana and ask them if Humana would like to enter the state and provide them with coverage, would it?
A Not that I know of. I don't think that would work.
Q So moving on in the Guidelines, let me direct your attention to the paragraph that begins at the bottom of Page 8 that reads, "Once defined, a relevant market must be measured in terms of its participants and concentration. Participants include firms currently producing or selling the market's products in the market's geographic area. In addition, participants may include other firms depending upon their

likely supply responses to a small but significant nontransitory price increase."

This is where we get into supply side response, don't we, Dr. McCarthy?

A Correct.

Q And looking at the language in the first sentence that I just read, this occurs once a relevant market has been defined; isn't that correct?

A In - in the flow of the Guidelines, that's true.

Q Thank you.

MR. ELLIS: Your Honor, I would move the admission of Exhibit P-96.

MR. TAUSEND: We have no objection.

MR. COOPERSMITH: No objection, Your Honor.

JUDGE FINKLE: Admitted.

Q (BY MR. ELLIS) Dr. McCarthy, in your testimony this morning you referred to the Aetna Prudential matter; is that correct?

A Correct.

Q And that was a civil antitrust case that was filed in 1999 by the Department of Justice concerning Aetna's proposed acquisition of Prudential; is that correct?

A I would - I would quibble a little bit. What it was was it was an investigation by the Department of Justice. They filed a complaint and a consent order simultaneously for

the - for the divestiture of a piece of Aetna in Texas. I wouldn't call it a civil action even though literally a complaint means it was a civil action, but it was an investigation where there was a settlement consent decree reached.

Q And the complaint was - and the investigation focused primarily on the potential impact of the acquisition on the market for healthcare in Dallas and Fort Worth Texas, didn't it?

A And Houston.

Q Dallas, Fort Worth and Houston, that's correct.

And as a result of the investigation and the filing of the complaint and the consent decree, Aetna was required to divest certain of its healthcare properties in the Dallas and the Houston markets, was it not?

A Yes, it was. They - they sold off their NowCare assets in those areas.

Q You indicated in your deposition that this case by the Department of Justice in some fashion supported your approach to market definition in this proceeding, didn't you?

A I - it wouldn't surprise me. I don't remember the particular discussion on that point, but I'm sure that's right.

Q But it is true, as you indicated this morning, that the

Department of Justice approach is - that was taken in this case is quite inconsistent with the approach that you have taken in defining the relevant market; is that right?

A I don't believe so, no. Quite inconsistent?

Q Yes. Well, for example, isn't it true that the definition of the product market included only commercial products and excluded Medicaid, Medicare and any other low-income plans? Is that right?

A The product market that the DOJ argued in its complaint was HMO and point of service plans, commercially sold HMO point of service plans. I don't - I don't think it included Medicare and Medicaid - Medicare and Medicaid HMO. I don't think it included that.

Q That's right. And, as you say, it only included HMO and POS HMO?

A Yes, in the product market. But, again, there are different measures that matter. One measure that matters is the capacity of your health insurance system to serve more of any kind of particular insured.

So you can look at the capacity - when you measure how much capacity a particular company has, Aetna, you can measure just as - just their commercial HMO point of service business or you can measure it as the amount of capacity they also use in self-insured because it was also only fully-insured business. It was a very controversial product

market.

And so you can talk about the capacity to serve as the self-insured, to serve the Medicares, to serve the Medicaid in determining how much capacity can be brought to bear in competition.

Q So the definition in that case of the product market by the Department of Justice included the HMO products and excluded PPO products, did it not?

A It did.

Q In your product market definition in this proceeding you have included all products and lines of business, haven't you?

Yes or no, please.

A I don't know what "all products" means. If you mean HMO and PPO, yes. So did Dr. Leffler --

Q That's right.

A -- include HMO and PPO in the same product market.

Q So the Department of Justice applied an even narrower definition of the product market; correct?

A No.

Q It did not?

A Narrow - yes, narrower in respect to HMO and PPO, but it didn't break it out by small, individual, large, small regulated, small unregulated. It didn't break it out that way.

Q And it excluded the low-income products; correct?
A To the best of my recollection, it excluded Medicaid HMO.
Q And the - with regard to the geographic markets that were alleged in the case, the Department of Justice did not define the market to include the entire State of Texas, did it?
A No, the geographic area - the Dallas/Fort Worth area was a 13-county area. It was the greater, if you will, Dallas/Fort Worth area. It included the rural areas that were tied economically and medically to the Dallas/Fort Worth area.
Q And that 13-county area is the Dallas/Fort Worth metropolitan statistical area, isn't it, a single MSA?
A I don't think it is, no. I think it actually goes beyond that. I think there are 13 counties in that MSA. I may be wrong, but I think it went beyond that.
Q And the Houston market was defined to include eight counties, wasn't it?
A That sounds right.
Q Was that the Houston MSA?
A That might have - that might have been Houston, Galveston, Corpus Christi . I'm not sure. I'm not sure if it is exactly contiguous with the MSA.
Q And to put these numbers of counties in perspective, how many counties are there in Texas?

A I don't recall.
Q If I told you there were 254, would you think I was wrong?
A It is a big place. Sounds like a large number, but I don't know the number, so I can't say you are right or wrong.

JUDGE FINKLE: Mr. Ellis, how much longer do you plan to be?

MR. ELLIS: Realistically, Your Honor, I think 20 minutes.

JUDGE FINKLE: I think we best take a break at this time. I'm going to ask counsel to check the time that's elapsed and give me a reality check either right after lunch or at the end of the day, at the latest, on how we are doing on the schedule. We will be back at 1:30 then.

(Lunch recess.)

JUDGE FINKLE: Let's resume, please.

Counsel, let's resume, please.

MR. KELLY: As a preliminary matter, you had asked about giving you an assessment . . .

As a preliminary matter, you asked before lunch if we could give you a rough assessment. And I'm not speaking for everyone, but just for Premera. But we did talk about what we are going to do this afternoon, which will be pretty firm. So we expect to also be able to call Mr. Lusk and

Ms. Donigan this afternoon. Friday, we have two witnesses that because of travel requirements need to get on and we are planning on Mr. Furniss and Mr. Kinkead. And then we have been disclosing other witnesses along the way.

I guess our overall assessment is we are going maybe a little bit slower, although I think some of the witnesses were necessarily going to be longer, the initial ones. And we think that we will probably be complete with our case, Premera, sometime into Tuesday, which is really not very far from what I was at least estimating, so I think we are moving along.

JUDGE FINKLE: Any scheduling reaction to --

MR. HAMJE: I'm not sure if I have any reaction to it other than to say it sounds consistent and logical.

JUDGE FINKLE: Assuming Premera completes its direct testimony Tuesday, let's say by the end of Tuesday at worst, is that consistent with your completing your testimony on schedule?

MR. HAMJE: Well, I'm not sure that we discussed this particular schedule according to days or anything like that. We do - have been keeping track of our hours. Our hours are where I would expect them to be at this point in the proceeding. I - an awful lot of what I would anticipate would be taken up with our witnesses is on cross-examination. And so that is something, of course, we

have no control over, but I would anticipate that it is possible that we could - if we started, say, Wednesday morning next week, it is possible we could finish up by Friday evening, if there was very little cross-examination or moderate amounts of it, but it is more likely that it would probably be on until - until the next week.

JUDGE FINKLE: What are the Intervenors' observations?

MR. COOPERSMITH: Well, Your Honor, counsel has conferred - Mr. Kelly has conferred with us and we expect that given what we anticipate to do on cross-examination on their witnesses, that a Tuesday close is realistic.

We have not conferred as extensively with OIC, so we don't know about its case in chief, but perhaps my colleague could address any concerns the bench may have about the length of the Intervenors' presentation.

MS. HAMBURGER: Your Honor, we have two witnesses that will probably need to go on the 17th and we have witnesses that are available both on Friday and, if necessary, on Saturday. I guess the length of our direct - I mean, for - our case really will depend largely upon how much cross-examination other parties expect to do of our witnesses. We do have a lot of witnesses, but we don't anticipate that they will use anywhere near the half-hour time for their presentations.

JUDGE FINKLE: How about Alaska?

MS. McCULLOUGH: I'm sorry. We weren't able to confer with Mr. Kelly, so we're not really sure how long - I think we are still deciding based upon the ruling that you made yesterday how many we believe that we will have for direct testimony, but I think probably two to three hours at most.

JUDGE FINKLE: Well, the concern that I have - and I suspect the Commissioner would share this - is to be fair to all parties and not run out of time and put undue pressure on the very tail of the proceeding, if - if the OIC staff is looking to use not only the three days available next week, assuming we conclude Premera on Tuesday, but also conceivably into the following week, I think the time will have elapsed without - without the witnesses all having testified.

We have a running total that will tell each of you - and I won't go over it now because you will have to work with it, what remaining minutes you have available, assuming we maintain the current schedule. So I'm just - it is just an early warning at this point, but I don't think anyone should assume that the hearing will be able to stay open indefinitely. We will have to stay close to, if not precisely on, the current schedule.

I will have to confer with the Commissioner about

running longer. We certainly have done it once and I think probably given that on a given day, particularly to finish a particular witness, but as far as adding actual hearing days, that's not ruled out, but it's one that's going to be difficult.

MR. HAMJE: Forgive me, Your Honor, but I had understood in the calculation of the minutes that that's a limitation that was designed so that we would finish on the 18th. Is that correct?

JUDGE FINKLE: That's correct. You know, what I'm hearing now from you about potentially with your witnesses' testimony, you know, you are mentally running into Friday, then we have got the Intervenors' case, perhaps, consuming a day or more and that doesn't build in any closing argument or any other issue.

So you have got the minutes that you know you have and you are good lawyers. I have been impressed with the orderliness of your presentations, your stability. I just am going to leave it to you for now. I raise it as an issue you want to be particularly attentive to. And I want everyone to understand that there is not a decision at this point to give you any additional time, so . . .

MR. KELLY: I think when I said Tuesday, I was really - I was thinking more midday, which if - that would then give us - have testimony of only a little over five

days if you knock out the opening morning. And that's about - then John would have four-and-a-half, five days, that would take it around on the following Monday and that would then, I think, be the balance of the time. So really I don't think we are off at this stage. It is just a little - and, of course, the more time we take on direct, which we have been doing a little bit more of, we'll pay for with shorter cross.

JUDGE FINKLE: Well, we are not in great shape if OIC staff's last witness concludes on Friday - a week from Friday leaving only one day for all the Intervenors' testimony and closing argument.

COMMISSIONER KREIDLER: Two days.

JUDGE FINKLE: Monday and Tuesday of the following week, yeah.

MR. HAMJE: Your Honor, may I make a suggestion?

JUDGE FINKLE: Go ahead.

MR. HAMJE: I think this is very useful for us to check in periodically. Maybe - today is Wednesday, we might want to check in again on Friday, maybe look at it Monday just - from time to time just to make sure that we are all kind of thinking along the same terms and we are on schedule, what we are thinking so that you all have an idea where we are coming from, too.

JUDGE FINKLE: No ruling or admonition - well, I

guess an admonition, but not a ruling intended. So let's keep track of it and please flag for me the issue if you really feel that we are off. And if we need to be thinking about where to find more time, we will examine that. I just don't want to get hit with it at the last moment.

Please continue.

Q (BY MR. ELLIS) Dr. McCarthy, you testified this morning that fairly early your career you were employed at the Federal Trade Commission; is that right?

A That's correct.

Q And that was back in 1982 and '83, as I recall, from your CV; is that right?

A Correct. That is correct.

Q And it is true that during that time period you did not - you were not actually assigned to work on any FTC cases, were you?

A I was not in the antitrust shop, the merger shop. I was in a department called the Division of Regulatory Analysis. And what I did was I looked at healthcare regulations and their effect on the functioning of the market.

Q You didn't work on any litigation?

A No litigation.

Q And since that time, it is true that you have not been retained by the Federal Trade Commission as an expert witness in any of their cases; isn't it?

A I have not been retained. I have been asked to come in and talk with them, but I have not been retained as a witness in one of their challenges, no.

Q And it also true that you have not been retained at any time in your career as an expert witness to work on a case for the Department of Justice?

A Correct.

Q In Premera's caring brief, there was a criticism of Dr. Leffler's analysis concerning the number of members that Aetna had in the State of Washington. Do you remember that?

A I do.

Q And the brief indicated, I believe - Dr. Leffler indicated that the total number of Aetna members was less than a hundred, Premera's brief indicated that it was more than 13,000 at the end of - or at the end of 2002; is that right?

A That was my reading of the brief. I actually have a slide to show that, if you would like.

Q I don't think we will need it. We can shortcut that process. I have a document that I would like to submit to you which has been marked as Exhibit S-111.

MR. ELLIS: If I may approach the witness?

JUDGE FINKLE: Yes.

MR. ELLIS: I should note, Mr. Commissioner and Judge Finkle, that this document was stamped attorneys' eyes only at the time that it was produced to the OIC, however I

have conferred with Mr. Tausend and I understand that Premera has no objection to its use in this public session at this point.

MR. TAUSEND: That's correct.

Q (BY MR. ELLIS) Now, Dr. McCarthy, you will notice there are - there is a Bates number stamped on the lower portion of the exhibit, if you turn it into the portrait mode, the number being OIC-EXP-NERA-9394 on the first page. Do you see that?

A I do.

Q Does that number tell you that this document was produced in this proceeding by your firm NERA?

A Yeah, but originally, of course, coming from Premera.

Q It did. And that's consistent, if you turn the document into its landscape mode, you see in the upper left-hand corner that it has the title "Premera Market Research, Eastern Washington Total Membership - Medical Based on Washington OIC Form B Reports as of December 31, 2002. Excludes All Self-Funded Business."

Do you see that?

A I do.

Q You will notice that the listing of membership for Eastern Washington, which is what the document addresses, includes two lines - two total lines for Aetna, which are the first two total lines in the listing. Do you see those?

A I do, yes.
Q One of them is for Aetna Health oh Washington, Inc., and lists the total number of members at 48 members. The seconds is for Aetna Health, Inc., a Washington corporation, which shows 56 members. Do you see those?
A Just to correct you - oh, I'm sorry. Yes, you are right. Yes, I see those.
Q So according to Premera's marketing research department, in this analysis as of the end of 2002 Aetna had a total of 104 members in Eastern Washington; is that correct?
A According to this, but there - you read the - an important caveat, which excludes self-funded business. Aetna has significant business and it has its own network in Eastern Washington, so this is - these data almost certainly come from the Form B data, which is a fully-insured business and doesn't - we know - and I can - I have another slide to show you this as well, that the - in the east there is an underestimate of enrollment of as least 17 percent. And that's really this sort of self-insured business that doesn't appear on this kind of data.
Q And I believe you testified that as to the self-insured business, there is no reliable source of that membership information, is there?
A That's not - no, there is no published source. And in that sense estimates have to be made that are less reliable than

actually collecting data. What I think I was talking about when I was talking about reliability of data was the counts of PPO lives, which is a little different thing but related to it.

Q Okay.

MR. ELLIS: I would move the admission of S-111.

MR. TAUSEND: There is no objection to S-111.

MR. COOPERSMITH: No objection, Your Honor.

JUDGE FINKLE: Admitted.

Q (BY MR. ELLIS) Now, Dr. McCarthy, in your prefiled responsive testimony, which has been admitted I believe as P-25, you testified that you found inconsistencies in the prefiled direct testimony of Lichiou Lee, do you remember that?

A Inconsistencies with some of the analysis done by the - in the PwC study, yes.

Q And you know that Ms. Lee is the lead health actuary at the OIC, don't you?

A I do know that.

Q And did you notice in her prefiled testimony, that she is a member of the Society of Actuaries and also the American Academy of Actuaries?

A I saw that in the testimony, yes.

Q Are you a member of either of those organizations?

A I am not.

Q She also testified that she meets the requirements of Washington regulations to perform as a qualified actuary, did you notice that?
A Yes.
Q Are you qualified under any state's regulatory scheme to act as a qualified actuary?
A No. I'm not an actuary and don't offer myself as one.
Q You have offered two studies that you have indicated will show the Commissioner that he doesn't need to worry about higher premiums or lower reimbursements or reduced accessibility to healthcare, right?
I am thinking of the Feldman study and the Hall Conover study.
A Oh, yes.
Q And the Feldman, Wholey and Town study, as you described it, was performed in connection with the proposed CareFirst conversion, wasn't it?
A Yes, but it looked at many, many, more conversions. They had a statistical analysis of 61 different conversions that had occurred, but it was in connection with that, not just only about Maryland. It was broader than Maryland.
Q And I believe that study was marked as Exhibit P-26 and has been admitted.
And then the Hall and Conover study was done in connection with the proposed conversion of Blue Cross/Blue

Shield of North Carolina, wasn't it?
A That's correct.
MR. ELLIS: And that has been marked, for the record, as Exhibit P-28. If I may again approach the witness, I would like to hand him pages from the - from P-28, the Hall Conover study.
JUDGE FINKLE: Go ahead.
Q (BY MR. ELLIS) Now, Dr. McCarthy, I would like to direct your attention to the second page of this document, which in the upper right-hand corner is labeled "Page 7 of 21" to the paragraph that begins at the bottom of the page and reads, "Beginning academic researchers have also looked at potential differences."
Would you read that paragraph to yourself, please, and let me know when you have completed it?
A (Complying.)
I have read it.
Q And that paragraph makes reference to the Feldman study that has been introduced into evidence in this proceeding, doesn't it?
A One of several cited, yes.
Q And Hall and Conover concluded that they could not really rely upon results of that and the other studies that were referred to in that paragraph, didn't they?
A I'm not sure what you mean by that, they couldn't rely on

them. They are citing them for certain propositions in premiums and quality - and profit levels.

Q Well, let me read into the record the following paragraph, which is the first full paragraph on the page labeled "8 of 21" where it says, "We hasten to note, however, that these findings" - referring to the studies in the previous paragraph - "do not resolve the issue before us, since they only look at HMOs, not at health insurers generally or Blue Cross plans in particular, which have a unique market status and operate in somewhat different market and regulatory environments than do pure HMOs. More important, such studies typically do not account for certain significant differences among patients enrolled in different types of plans. In Medicare HMOs, for example, the people in for-profit plans are much poorer and less educated than their counterparts in not-for-profit plans," citing Blustein and Hoy 2000.

"Of even greater importance, only one of these studies compares plans before and after a conversion. All the others compare nonprofit HMOs with for-profit HMOs. Since many resulting from the conversion" - I'm sorry - "the studies" - let me go back to the start of that sentence.

"Since many of the nonprofits are BC plans" - I assume, Dr. McCarthy, BC refers to Blue Cross - "and most of the for-profits are not, these studies provide only limited

insight into differences resulting from the conversion of a BC plan. Finally, evidence of financial performance from many years ago is a questionable relevance in today's marketplace. Therefore, we return to the path on which we began: Examining the challenges that are likely to result from increased pressures to generate profits."

MR. TAUSEND: The word is "changes," not "challenges."

Q (BY MR. ELLIS) Changes. With that correction, did I read the paragraph correctly?

A It seemed to me that did you.

Q Thank you.

And Hall and Conover in this study concluded that there are potential concerns about the effects on premiums and on reimbursements to providers from conversions, didn't they?

A Potential is a big word. What they - what I interpret their finding to be is that they can't say that there is a consistent pattern that is negative or positive from the research that they did, from conversions. So potentially, yes, but there is also potential benefits.

Q And let me read into the record a portion of their conclusion appearing on the last page of this document, which is labeled "Page 17 of 21" in the third paragraph of the conclusion where the author states, "One clear effect of conversion is to increase profit incentives. Therefore the,

areas of greatest potential concern can be mapped according to the main components of profitability: Rates, administrative costs, and medical claims. Conversion may result in higher insurance rates in those market segments where BC plans hold considerable market power and are subject to less aggressive rate regulation. Conversion also tends to result in lower medical loss ratio, which can be achieved by tougher negotiating with providers and more refined underwriting and risk selection practices."

Did I read those sentences correctly, Dr. McCarthy?

A Yes, but the first paragraph also gives their conclusion for the overall study, which if I can read that says, "We did not detect any major negative health policy effects so far from freestanding conversions of Blue Cross plans in the states where they have occurred."

Q So the conclusions are quite mixed?

A Exactly right.

MR. ELLIS: I have no further questions. Thank you, Dr. McCarthy.

THE WITNESS: You're welcome.

MR. COOPERSMITH: Good afternoon, Dr. McCarthy. Are you ready to proceed?

THE WITNESS: Yes, fine.

CROSS-EXAMINATION

BY MR. COOPERSMITH:

Q Just for the record, you are - you are a doctor of economics, not a doctor of medicine, so the only way you can deal with sickness is through the art of economics?

A I like to think of it that as long as I preserve competition, that will be good for patients.

Q Okay. Let's talk about your background, your work prior to this case. You never worked on healthcare matters in Washington except for the limited brief work that you did on the Swedish Providence Hospital merger prior to this; is that correct?

A I don't know what you mean by "limited work." There was some - it was over a period of months, but yes, we worked on Swedish's acquisition of the Providence Hospitals within the Seattle area.

Q And you testified at your deposition that you thought it took anywhere from three to six months; is that correct?

A I think that's right.

Q Okay. And that merger was a friendly one, was it not?

A Yes, it was.

Q And you have also represented the HMO side in several class action suits brought by subscribers; is that correct?

A What I - those subscriber class action suits, just for the record, have - they are still technically alive, but they

have disappeared because --
Q Mr. McCarthy, you are going to need to answer the question posed. I didn't ask about the status of the cases. I asked whether you represented the HMO side in cases brought by subscribers that were class action in nature.
A We didn't get far, so the answer is yes.
Q Yes, you represented the HMO side in those cases, correct? Yes or no?
A I represented - I was retained by lawyers who represented those people, yes.
Q They are --
A They are multiple class action suits.
Q And --
MR. TAUSEND: Your Honor, can counsel let the witness finish his responsive answer?
JUDGE FINKLE: We are going to have a problem. Try to answer just the question that is posed. You will have redirect. We'll try to keep this straight, but do allow an answer and do try to confine the answer to the question.
THE WITNESS: Yes, Your Honor.
MR. COOPERSMITH: Thank you, Your Honor.
Q (BY MR. COOPERSMITH) And, in fact, Mr. McCarthy, you have done extensive work on behalf of health insurance companies; is that correct?
A I have done work for insurance companies and everybody else

in the health industry.
Q That's a yes?
A That's a yes.
Q All right. And have you ever worked on behalf of physicians in opposition to a health plan?
A Indirectly in some mergers, yes. When physician plans would merge, there would be - it wasn't a litigation, but it would be something that an insurance company would at least concern themselves with.
Q But that was not in direct opposition to a health plan; is that correct?
A There was no litigation.
Q Have you - have you ever worked for physicians where the health plan was a direct adverse party?
A I think adverse party would be yes. In a merger they are an adverse party in many cases.
Q Why don't you explain that situation for us?
A I helped to merge the Sansom Clinic with Foundation IPA in Santa Barbara. There were some insurance companies who didn't like that merger. I helped to merge two hematology/oncology practices in Santa Rosa. They became the only hematology/oncology practice in Santa Rosa. Some insurance companies didn't like that. That is adverse to the insurance companies from the insurance company's point of view.

Q Have you ever worked directly for a patient or a patient group against a health insurer?
A I have never been given the opportunity, no.
Q And has your firm ever done so?
A Not that I know of.
Q Turning now to the work you have done in this matter, how much time have you spent in Eastern Washington, Mr. McCarthy?
A I have not been to Eastern Washington.
Q And other than Premera personnel, did you or anyone at NERA speak with any physicians in Washington to reach your conclusions?
A What we did - the answer is no, we didn't interview --
Q Thank you.
A -- physicians. We looked at data about physicians.
Q Thank you.
And did you or anyone else at your firm speak with any physician groups, such as WSMA or specialty groups or county medical societies?
A We used their data. We didn't talk to them.
Q And same question with regard to hospitals. Did or your firm speak with any hospitals in our state?
A We used their data. We didn't talk to them.
Q And did you speak with the Washington State Hospital Association?

A There is the data I'm talking about actually.
Q Okay. But the question was whether you spoke to anyone at the association --
A No. No.
Q -- to reach your conclusions.
And did you speak with any patient or patient groups in order to reach your conclusions?
A No.
Q Did you speak with Regence Blue Shield?
A No.
Q Or Aetna?
A No.
Q Or CIGNA?
A No.
Q Or First Choice?
A No.
Q Health Net?
A No.
Q Did you speak with any PPO or any carrier in this state to reach your conclusions?
A Yes.
Q Which?
A I interviewed brokers one of which --
Q I asked - wait, wait, wait.
A Hang on. One of which was Marsh Advantage that has a

network and offers a product.
Q Okay. We will get to the brokers in a minute, Mr. McCarthy. Other than Marsh Advantage, did you speak to a PPO or carrier in the state to reach your conclusions?
A No.
Q And would the same answer apply to your firm as a whole?
A Correct. We used public sources.
Q All right. And in your - pardon me. In preparing your reports, Mr. McCarthy, it is fair to assume that you didn't have any access to confidential proprietary information about your - about Premera's competitors; is that correct?
A Not entirely. It is close to correct. There were a few things that were attorneys' eyes only and outside experts only.
Q And you used that information in preparing your report?
A I think we had it for the first report, yeah. I think it is in the first report.
Q Do you need to refer to your deposition testimony to refresh your recollection or --
A What I'm referring to were the comparisons of conversion factors with - between Premera and some other companies, First Choice, Group Health - First Choice, Group Health and Regence.
But it does - it does refresh my recollection. At my deposition I produced some preliminary tables on that

because we had just gotten that data from Dr. Leffler the night or two before my deposition. So it probably wasn't in the report, but it was something we talked about in the deposition.

Q And, therefore, the question was whether in preparing your reports you had - relied on any confidential proprietary information from Premera competitors? If you would like to answer that question.

A Yeah, and I'm reminded that actually that came after the report was prepared just before my deposition. So the answer, the report does not have anybody else's data in it.

Q Okay.

A Confidential data.

Q Okay. Is it fair to say that most of the information about competitors that you relied on in this case came from company websites and annual filings with the OIC?

A No.

Q Okay.

A Not most. Not most. We had a lot of publicly available information from reports like - Health Leaders is what they are called now. They used to be called Gartner reports, but they are reviews of the market.

Q And --

A We used those as well.

Q Did you rely on anything else?

A Conversations with Premera, interviews with brokers.
Q Right, we will get to the brokers in a minute. Other than conversations with your client?
A Well, publicly available data as well as the data from the OIC that helps you to understand the market.
Q It is fair to say that you didn't have access to any of Premera's competitors business plans? Is that correct?
A That's correct.
Q All right. And you mentioned, now a couple times, that you spoke with brokers. You spoke with three of them in all in this state; is that correct?
A I think that's right.
Q And those conversations lasted for about a half-hour a piece; is that correct?
A That's reasonably correct, 45 minutes. I don't know.
Q Okay. Why don't we turn to what has been marked - I believe it is marked and admitted as Premera Exhibit 22. Is that your - the report that you filed in this matter?
A I don't have Premera 22 in front of me.
MR. COOPERSMITH: Thank you, Counsel. Thank you very much.
Q (BY MR. COOPERSMITH) Do you now have Premera Exhibit 22 in front of you?
A Yes, I do.
Q And can you identify that for us? That is a copy of your

expert report that you filed in this matter; is that correct?

A It looks to be, yes.

Q Okay. Can you turn Page 22 of that report?

A Yes.

Q And I want to turn to the subject of ease of entry into the Washington State health insurance market. Turning your attention to Table 6 and the first company you list there is the United Health Group entering the market in 1995; correct?

A Yes.

Q And are you aware that United health ceased marketing two years later?

A Yes, but they achieved membership in the 20,000s in the interim and then decided to leave the state.

Q All right. And are you - the next is First Choice; is that correct?

A That is next on the list.

Q And you indicate that they entered the market in 1996 and the license type is HCSC; correct?

A Yes.

Q And that stands for healthcare service contract, does it not?

A That's my understanding.

Q Okay. And are aware that First Choice is not accepting any

new enrollees in their HCSC license for a year?
A Yes. They have become or on their way to becoming a rental network only.
Q So are you aware that they filed with the SCC a formal notice that they ceased doing business operations in this state under the HCSC license?
A I wasn't aware of that, but I knew they were phasing out the insurance side of their business.
Q Okay. The next insurer that you list there is Great West; is that correct?
A Yes.
Q Entering the market in 1997. Are you aware that Great West has a less than one percent market share in this state?
A Yes. They, too, have gone up and down.
Q And it is less than one percent now?
A I don't know the exact number, but it is not a big number.
Q Okay. And the fourth carrier you identified there is Molina; is that correct?
A Yes.
Q And you have already agreed with Mr. Ellis that Molina serves low-income patients only; is that correct?
A Yes. Yes. Once they got into the market and settled, they bought a company that had commercial lives.
Q Mr. McCarthy, you are just going to need to answer the question.

A You wanted to know about their entry. I'm telling you about their entry.
Q Okay. Is it true that Molina serves low-income patients only now?
A Yes, it is true.
Q Thank you.
And the fifth and final carrier you list is Health Net; correct?
A Yes.
Q And that entered the market in 2002; correct?
A Yes.
Q And are you aware that in this market they have only a single defying contribution plan with fewer than 10,000 enrollees?
A Yes.
Q Okay. You don't list the entry of Principal into the market, but you're aware that Principal is no longer in this health insurance market; is that correct?
A I don't remember that, but that wouldn't surprise me. Principal has been in and out of markets.
Q And are you aware that Mutual of Omaha departed the Washington State health insurance market as well?
A Yes.
Q Okay. Why don't we move, then, to your argument about the ease of expansion.

MR. COOPERSMITH: Counsel, could you do me a favor and put back on the screen the slides that Mr. McCarthy used on his direct examination?

THE WITNESS: Which would you like? It is controlled up here.

MR. COOPERSMITH: Oh, thank you. If we could go first to Slide Number 5. I think it is examples of product line expansion.

THE WITNESS: Is this the slide you want?

MR. COOPERSMITH: No, it is nine. Yes, thank you.

Q (BY MR. COOPERSMITH) All right. The first one there is First Choice HMO; correct?

A Yes, it is.

Q And you are aware that that product is gone, correct --

A They made --

Q -- from --

A They made a stab at it and decided not to offer it. They pulled out.

Q Okay. I take that as a yes.

The next one you list is First Choice Medicare Managed Care. And you are aware that that product is gone as well; is that correct?

A Same thing. They came into the market. They tried the best they could. They didn't stay in the market. They pulled out.

Q All right. And the - then you list Aetna Defined Contribution Plan and then the next one is Regence Defined Contribution Plan; is that correct? Self-insured?
A Right.
Q All right. And are you aware that the enrollment there is insignificant in that there is no growth in that product?
A Well, no, I'm not aware there is no growth. This is - this is one of the products that's like the use of like product. We just looked at it for Health Net. This is one of the products that has been growing nationwide very well and is expected to grow here well.
Q Are you aware that it has a very, very small enrollment at this time?
A I don't know the exact number.
Q Would - do you think it is a larger number?
A No, I don't think it is a large number.
Q Okay. And it has been in this market for three years; is that correct?
A It has been offered for that many years.
Q Okay. Thank you.
A The point is they added a product --
Q Thank you.
A -- to their other product.
Q Mr. McCarthy, again, I appreciate you answering the questions asked.

Why don't we turn to the next slide, which is an example of geographic expansion.

A Yes.

Q And the first one you list there as an insurer is King County Medical. You are aware that King County Medical no longer exist as a company in this market; correct?

A It is the predecessor of Regence.

Q It no longer exist?

A Correct.

Q Thank you.

And you are aware that - you list First Choice there as an insurer, but that is now strictly a PPO; is that correct?

A I would say it is even strictly a rental network, but that has other effects.

Q It is no longer an insurer as listed there; correct/

A Correct, but it was when it expanded into Eastern Washington.

Q And the next insurer you list is NYLcare and you are aware that NYLcare is no longer in this market either; is that correct?

A Aetna purchased NYLcare.

Q I'm just asking if - if - if the company NYLcare operates in this market.

MR. TAUSEND: Your Honor, I think --

A It doesn't operate --

MR. TAUSEND: -- he is clarifying his answer.

JUDGE FINKLE: I think you need to confine your answers. And, as you know, you are able - able, Counsel, to redirect is necessary.

Go ahead, please.

MR. COOPERSMITH: Thank you.

Q (BY MR. COOPERSMITH) Let me ask the question again. The question was whether you are aware that NYLcare is no longer doing business in this market?

A I'm well aware of that. We did the merger.

Q Thank you.

And are you aware that Northwest One is not now an insurer in this market, but strictly a PPO. That's the final insurer that you list there under the category "Expansion from Western into Eastern Washington."

A I'm aware it is a network rental entity.

Q Okay. Thank you.

And the next category you list on that slide is "Expansion Within an Existing Region." We have just discussed NYLcare. Can you turn now to Sisters of Providence? Are you aware that that's employees only? That only employees of Sisters of Providence can enroll in their plan?

A I'm not aware of that. That's not - I think it was - it started as a provider-based plan, but I don't think it has

always been a provider-based plan.
Q So you are not aware of what Sisters of Providence's - the configuration of its business is at this point?
A I don't remember with a certainty, but my recollection - my recollection is that it sold commercial insurance though it is not selling commercial insurance in places - in at least most places now.
Q Okay. And you described Asuris as a large competitor to Premera in Eastern Washington; is that correct?
A I - we can look through. I may have used that word. It is a significant competitor.
Q In your responsive testimony that you filed and has been subsequently admitted, you described it on Page 7 as "a large competitor to Premera in Eastern Washington."
Do you stand by that statement?
A It - the answer is yes, I stand by statement. I think it has to do with the - I think it is in the context of other companies which don't necessarily have large enrollment in Eastern Washington, but they are large companies that are significant competitors because they have that capacity.
Q And, Mr. McCarthy, you are aware, of course, that Asuris is the unbranded version of Regence in the Eastern Washington area; correct?
A I'm aware of that.
Q And you were present when other Premera test- - withdraw

that.

You were present when other Premera witnesses testified and stressed the importance of keeping the Blues brand; is that correct?

A Yes. For probably not all of it, but yes.

Q Right, you did hear that testimony. Is that testimony that you agree with?

A That the brand is important? Yes.

Q All right.

A I agree it is important.

Q And --

A It is an asset.

Q And do you believe that Asuris is ever going to be able to compete with Premera - with Premera in Eastern Washington without the Blues brand?

A Sure.

Q And how is that?

A We have also heard testimony about Blues brands that are in trouble. And if the Blues brand is such an automatic, check-writing asset to have where everybody makes money just because they have the Blues brand - you know that in lots of other states you got to do more than just have the Blue brand, the Blue mark in order to be successful.

So the answer - the answer is that competition pushes all of the Blues plans and sometimes the Blues get in

financial trouble as a result.
Q And I had a much narrower question which was what led you to believe that Asuris as an unbranded Blue would be able to compete in this particular segment of the market in Eastern Washington?
A The experience in other states and the fact that it has come in and it is growing. The fact that it is adding products. The fact that it is backed by Regence. The fact that Regence in the past several years has realized it has got to be bigger and has joined Regence Alliance, which is Utah, Oregon, Washington and Idaho, in an alliance to be bigger and stronger company. So my - my - my forecast for them is that they will be a strong competitor in Eastern Washington.
Q Do you believe that up until now Regence has not committed substantial time and resources into trying to make Asuris competitive with Premera in Eastern Washington?
A Do I mean that they have - do you mean that they haven't competed to date and they are only starting? No, I don't --
Q No, I asked whether you believe that Regence hasn't yet committed time and resources to try and make Asuris competitive in Eastern Washington with Premera.
A It is trying to compete. It has been trying to compete.
Q Thank you.
And you are aware that CIGNA represents less than one percent of the state's insured population; is that correct?

A I didn't think we believed in the statewide market.
Q What's that?
A I didn't think we believed in the statewide market.
Q I'm just asking you the question.
A They are not large in the State of Washington, but, again, it is a tough market and they can be large if the opportunity presents itself.
Q I'm just asking you about the current situation.
And with regard to Aetna, are you aware that Aetna represents just over one percent of the regulated market in this state?
A I don't know about just the regulated market. Aetna has a - one of the exhibits you have but in the record indicates they have over 500,000 members statewide.
Q Right, I asked about the regulated.
A I don't know how that breaks down.
Q Okay. And PacifiCare is only in Medicare Managed Care; is that correct?
A I don't think that is correct. The interview notes that OIC did with the broker showed PacifiCare has moved into Eastern Washington for - I understood it to be commercial business.
Q All right. You - in speaking with Mr. Ellis earlier, you agreed that Community Health Plan doesn't offer private insurance coverage; is that correct?
A That's - assuming what you mean by "private," yes, that's

correct.
Q All right. And are you aware of any plans by Community Health Plan or Molina to start offering private coverage in this state?
A I know of no plan.
Q All right. And is it fair to assume that you have never personally tried to build a provider network; is that correct?
A I think that's safe.
Q Okay. And your analysis shows that there is a disparity between what Premera pays providers in Eastern Washington versus what it pays in Western Washington; is that correct?
A No.
Q Is it not fair to say that on average Premera pays providers less in Eastern Washington than it does in Western Washington?
A I don't know where you find that result. I think the results I have presented to you show that there is no significant difference when you hold aspects of what is being performed constant.
Q There is some - I know you characterize the differences as insignificant, but is there a difference between what Premera pays in providers in Eastern Washington versus Western Washington?
A Hmmm. There is some information - you may be referring to

the material we got from Dr. Leffler about the comparison with Regence and --

Q I don't want to get into that area. I just want to ask whether you do agree with that --

A There is - there is some calculations with very modest differences in them. You are talking about Eastern versus Western?

Q That's correct.

A I don't know the information that you are calling to mind because I can't call it to mind.

Q Okay. Let's assume for purposes of this question that if Premera pays providers less in Eastern Washington than in Western Washington, would it then be true that the more Premera patients you have in your practice the larger the impact that would be on your practice?

MR. TAUSEND: I object to the question as based on no evidence in the record and not stating anything that is before the witness.

JUDGE FINKLE: Well, I will take it purely as a hypothetical question. And with that reservation, go ahead and answer.

MR. COOPERSMITH: Thank you.

A It seems like an arithmetic certainty. If somebody pays you less and they are a big part of your practice, then it has more of an effect. That's what I take your question to

mean.
Q Yes.
A Well, that's defined by the question.
Q Okay. Thank you.
And then you believe that physicians - if Premera is not offering physicians a competitive reimbursement rate, that physicians can simply contract with other payers; is that correct?
A Yes. The way it is normally done is a physician will close his or her practice to the - to the insurer that they are not interested in dealing as much with. They don't usually - they sometimes just don't sign a contract. But if it is a significant part of their practice, they just close the practice.
Q And do you believe that physicians in Washington State are able to do that, to simply not decide to contract with Premera because it doesn't offer competitive or attractive reimbursement rates and then contract with other payers instead?
A They can. Sure they can.
Q And are - are physicians and other providers able to do that if Premera constitutes a large part of their practice?
A It makes their adjustment harder and longer, but they can do it. And that's why they would close the practice and try to work with other insurers and other patients.

Q So how long and hard would you expect the adjustment to be if Premera constituted 20 percent of a provider's practice?
A I don't know.
Q How --
A It depends - we heard from Dr. Gollhofer that they are pretty busy in Eastern Washington, which is where I presume you are talking, where Premera would be a large part of their practice.
Q No, actually there is no geographic distinction here. This line of questioning applies whether you are in Eastern or Western Washington. And the question was simply whether - you said it would be a longer and harder adjustment when a physician or other healthcare provider had a significant portion of Premera patients in his or her practice; correct?
A Yes.
Q And I asked whether --
A That's true in Western Washington as well.
Q And I asked whether the adjustment would be longer and harder the more patients that the physician had in the practice?
A As a general matter, yes, but that doesn't mean that it is an impossible task.
Q And so it is fair to assume that if the physician had more than 30 percent in her practice, it is harder than if she only had 20 percent in her practice; is that a fair

assumption?
A It depends on a lot of things. It depends on what practice they are in, whether it is a growing area, whether there were lots of insurers in that area. It depends on lots of things.
Q Okay. And, finally, Mr. McCarthy, how much has Premera paid your firm for their work that has been done on its behalf?
A I don't know. I - I'm not in charge of the billing. I don't know what the numbers are. It is a significant number, but I'm told significantly less than the OIC experts.
Q Is it over $10,000?
A Oh, yes.
Q Over $100,000?
A Yes.
Q Over $300,000?
A I believe it is, yes.

MR. COOPERSMITH: No further questions of this witness at this time.

JUDGE FINKLE: Any other Intervenors questions?

MS. McCULLOUGH: No, thank you.

JUDGE FINKLE: Redirect?

REDIRECT EXAMINATION

BY MR. TAUSEND:

Q Let me start, Dr. McCarthy, with a line of questioning that Mr. Coopersmith was pursuing in the exhibit up on the board. What, in your conclusion, is the significance of the entries, expansions and in and out retractions, fluctuations, that you have talked about in giving examples of geographic and product expansion?

A Even though you look at a lot of these firms and a lot of these products and you say they failed or they decided to become a network instead of a fully insured company, it is exactly the ebb and flow of competition. And what - what this tells us - one of the most important things it tells us is that there aren't a lot of sunk costs to go into a product or to go into a market - geographic area. When I say market in that sense, go to a geographic area, put your toe in the water and see if you can make some money. And if you can't, you pull out. And so the fact that there is exit as well as entry is part of the competitive process.

Also, it is important to understand that in a lot of these - in the criticisms that have been raised against some of this entry and what the enrollment numbers are, those are fully-insured enrollment numbers. They are fully insured. Sometimes they omit PPOs. Those are data that are hard to come by.

We did an analysis that looked at the state - or looked at Eastern Washington, particularly that focus, and tried to figure out how much is the undercount. And there is something like - you can look at all the Form B data and you can look at all of Premera's enrollment and you find a few other slices, like we have more information about Aetna.

And let me actually show you what it comes out to be. This is what it looks like. When you - when you - for Eastern Washington, when you try to figure out where everybody is, try to count them up, there is at least 17 percent that we can't account for, which means that they are in the self-insured, the PPOs that aren't counted.

So combining this sort of ebb and flow with the undercounts that we observe in, for instance, Dr. Leffler's criticisms and that the kind of number that Mr. Coopersmith just put in front of me, there are really a lot more lives than those that are listed.

Q And can you state whether the process of in and out entry and retraction and so forth that you talked about has any effect on the behavior of a would-be monopolist?

A Yes. One of the things to keep in mind, there has been no attempted monopolization. There is no exercise of market power going on. We have no evidence of market power being exercised.

You still have a few examples of exit and entry, entry

of expansion and exit. There is still people trying to make money even at these - these - these strong competitive conditions that have led to the kinds of margins that we have seen, the kinds of underwriting margins we have seen.

So it is not exactly a market where you would expect robust entry. It is not a highly profitable - particularly Eastern Washington, given the density of population, is one of the lesser attractive markets for any insurer to serve. And that's - that's - it is a difficult place to enter and to do well.

Q Mr. Ellis asked you some questions about the Hall and Conover report and read you some sentence - selected sentence from it. That's Exhibit P-28.

Rather than reading you other sentences, I would like to ask you overall what you conclude are the conclusions of that report?

A I think that their reaction is a lot like everyone's reaction to a for-profit conversion. The assumption is that something is going to change, that the incentives will be bad. But when you look at the evidence, the evidence is always mixed.

And what explains the mixed evidence is competitive forces. Competitive forces constrain for-profit providers. They constrain not-for-profit providers. And as I said in my responsive filing, it may seem odd, but shareholders of

for-profit companies care very much that their company does a good job, that the quality is good and that prices are good, because otherwise there will be no revenues. They will sell nothing. They will have no profits because nobody is interested in their product.

So I interpret Hall and Conover to be saying anything can happen. Sometimes it is up, sometimes it is down. Sometimes quality is up, sometimes it is down. But that the results are mixed and that there is nothing systematic that can be predicted from any one conversion.

I would only add to that that based on the study that we have made of both the selling and the buying side this would be a market where you could - I believe you can rely on the forces of competition.

Q Let me go back now to the beginning of the cross-examination by Mr. Ellis and call your attention to the Merger Guidelines.

Dr. McCarthy, what is the function of the Merger Guidelines and how are they used?

A They are just what they are labeled, guidelines for analyzing mergers. They have some - some differences, even though the basic principles for - for identifying market power, market definition are consistent with monopolization cases. Monopolization cases, which is what we would be interested in here, the exercise of market power as a

long-run phenomenon, are somewhat different. That is point number one.

Point number two is the merger guidelines are not used exactly the way they are written. In the merger guidelines there is a lot of room for the supply response. Supply substitution is what we called it in the - in one of the first instances. And when you get to actually identifying a market that the Federal Trade Commission will bring to court or the DOJ will bring to court, it is a market that has considered supply substitution.

And we can go into examples, if you want, but a simple example would be almost any hospital merger is done as total acute care. It is not done as a single product like having a baby or having our appendix removed. It is done as total acute care.

Q And does that go, then, beyond demand substitution? In other words, what - would a woman who went in to have a baby delivered also substitute having an appendix taken out at the same time?

A Let's take it a step at a time. If we follow the chain of logic that Mr. Ellis read to me and said we were only going to talk about demand substitutes, the argu- - the question would be asked is a woman who goes in to have baby interested in having an appendectomy instead just because the price fell? And we all know the answer to that, no.

They are not demand substitutes.

If you followed the demand substitution principle, any hospital merger would have to consider is there a separate market for having babies, appendectomy, brain surgery, hernias, whatever the patient's problem was? Would you have to have an individual product market for each and every one?

The Federal Trade Commission and the DOJ have both brought merger challenges to hospitals and have never, ever gotten anything close to a single product. It has always been, most often, total acute care, occasionally tertiary acute care, meaning the higher level care, but they never go with just a demand substitute product. And that's their own guidelines. They are bringing these cases under their own guidelines.

Q Have you participated in hospital merger cases yourself?

A I have probably done about a hundred hospital mergers.

Q And you gave one example of how the guidelines were applied in hospital mergers. Do you know any exceptions to that?

A In hospital - anything - again, I'm not sure if you are asking - tertiary care is sometimes - there is sometimes a smaller grouping of services, but it is always more than the single service than a demand substitute would imply.

Q Lastly, I want to call your attention to the Aetna Prudential case that you were asked about.

A Yes.

Q What is there about that case that is distinctive or --
A Well, two things. One is that case was never tested in court and - and the antitrust courts have not been friendly to the distinction between HMO and PPO being separate markets.

Maybe if you are familiar with the Marshfield Clinic case where Judge Posner (phonetic) said there is no separate market for HMO and PPO, that's one distinguishing factor. It was never brought to court.

The second distinguishing factor is it only applies to Texas. Texas has a regulation that did not allow gatekeeper PPOs. And if you think about how products compete and how they - how they substitute for one another, one of the bridge products from a pure HMO - we used to have pure indemnity and pure HMO and then all these bridges got built in between. We had HMO with a point of service. We add PPO with gatekeepers that would, you know, help to manage care. And as they all got closer in their characteristics, they became close substitutes.

Texas did not have - in fact, by regulation, could not have a gatekeeper PPO. The Department of Justice - we did that merger. The Department of Justice said that that was a distinguishing feature that essentially drove a wedge between HMO and PPO and separated their product.

Q And how does that apply here?

A It doesn't. As best I know, there is no such rule. As a matter of fact, the world has changed dramatically. We all know the world has shifted away from HMO to PPO.

MR. TAUSEND: I have no further questions at this time. I would like to reoffer at least Pages 9 and 10 of Exhibit 35 as demonstrative because they were used extensively by Mr. Coopersmith. Those were two on the screens of the example of geographic expansion and examples of product line expansion.

MR. COOPERSMITH: We don't have any objection.

MR. ELLIS: No objection.

JUDGE FINKLE: Admitted, and just - just 9 and 10. That doesn't change the earlier ruling.

MR. COOPERSMITH: Correct.

MR. TAUSEND: That's all I offered.

JUDGE FINKLE: Further cross?

MR. ELLIS: None here, Your Honor.

MR. COOPERSMITH: Two quick questions, Your Honor.

RECROSS-EXAMINATION

BY MR. COOPERSMITH:

Q Mr. McCarthy, looking up at the graph that is displayed now, Page 33, in the section that says, "Other insurers, 43 percent," does that include insurers who only offer Medicaid

and BHP coverage?
A I think it involves all commercial insurers so - I'm sorry, say it again, which ones you wanted to know about.
Q I wanted to know whether it included insurers who offered Medicaid and BHP coverage.
A Yes.
Q And using your own examples of health insurers that have entered the Washington State market, is it fair to say - fair to characterize this marketplace over the past couple of years as more in-and-out than in-and-stay-in?
A I don't know. I think it is mixed. And the reason - the reason I say that is a lot of - there was a certain cataclysm in the - cataclysm in the individual market in the State of Washington in the late '90s. And everybody got out in the sense of selling new products. For all intents and purposes, everybody was out.

Regulatory reform followed and people came back in. Medicare HMO had the same sort of problem. The Feds stopped funding it as well as they used to fund it and virtually everybody had to pull out. There were few who didn't. Kaiser Group Health, some of the others didn't.

They are now restoring some of those cuts in the PBA. People will be back in. I'm confident people will - many insurers will come back in. So there is an in-and-out element to it that I think is predictable by what has been

going on in the market nationally.
Q Is it your testimony, then, that what accounts for all the departures from the Washington State insurance market was the collapse of the individual market and the Medicare Managed Care markets?
A No. What accounts for the exit is strong competition. And it is hard to - it is hard to compete unless you bring a good product at a good price.
MR. COOPERSMITH: No further questions.
MR. TAUSEND: I would just now offer that slide, Page 32 of Exhibit 35.
MR. COOPERSMITH: That slide meaning which one?
MR. TAUSEND: The one that you asked about.
MR. COOPERSMITH: We object to - we would object to that one.
THE WITNESS: If I could just clear up - the difference is 32 is the underlying numbers for the picture in 33. I was flipping back to see if I could answer his question more precisely based on what the calculation was and the information wasn't directly there.
MR. TAUSEND: I think there is no objection to 33.
MR. COOPERSMITH: Yes, there is an objection to 33.
JUDGE FINKLE: Is there an objection to 32? I don't know, maybe it is not being offered.
MR. TAUSEND: No, actually that's what I started to

offer.

JUDGE FINKLE: That's what I thought you --

MR. TAUSEND: And I wasn't sure what Mr. Coopersmith was objecting to.

MR. COOPERSMITH: We object because we don't think that - it is just a summary of his testimony and we think it is demonstrative only.

JUDGE FINKLE: Can you just flip back for a minute?

THE WITNESS: Certainly. Any position on this? I don't want to ignore you.

MR. ELLIS: No.

JUDGE FINKLE: Admitted.

Anything further?

MR. TAUSEND: Nothing further.

JUDGE FINKLE: Anything further from OIC staff?

MR. ELLIS: No. Sorry, Your Honor.

JUDGE FINKLE: Commissioner?

EXAMINATION

BY COMMISSIONER KREIDLER:

Q Dr. McCarthy, at several times you referred to Washington State as being a tough place to do business. I wasn't too sure what you meant relative to the insurance business - health insurance business what that meant.

A That's a fair question. What I meant was that it is a competitive area. Eastern Washington is very price sensitive, as least according to the brokers we talked to. And what I mean - I mean competitively tough. I don't mean that the business climate is necessarily antagonistic. I mean it is a tough place to operate.

Q Is that true for the whole state or - as opposed to Eastern Washington?

A I think it is true for the whole state. Western Washington is considered - just by the numbers of players and the relative sizes of the players - is considered to be - I mean, everyone pretty much assumes and accepts that it is a very competitive market in Western Washington.

What I think is maybe less well understood is how price sensitive Eastern Washington is. It is very much a small group market and those are small employers who watch every penny. Not that big employers don't care. But that it is a very - we are told it is a very price sensitive market and you can get people to switch for, you know, five percent savings.

Q I was aware, you know, of that Eastern and Western Washington difference. I think it was the context of the state as a whole, as to what the differences are. I think you covered that.

You also talked about your competitive process as

opposed to market share being the - where we should have our focus, that being on competitive process as opposed to market share. I'm not exactly sure what constituted competitive process.

In other words, what facts should be considered in determining the process to be a competitive one?

A Okay. Sort of the summary statement of it is those supply responses reflect mostly the competitive - all three of them - all three of them can discipline any sort of excessive or what we call supracompetitive price increase. So the competitive process is, in fact, responding to anybody's attempt to raise prices too high.

Now, you can have very large shares, but maintain those large shares only because you are pricing very competitively. You are behaving efficiently. You are offering a product that consumers like and, therefore, they keep supporting you.

The moment you raise those to supracompetitive, that is outside the band of what would be reasonably thought of as a competitive price, that's when there is a market opportunity for anybody who is already in the market and for people like supply substitutes who could very readily come into the market without a lot of sunk costs as well as for new entrance. So really it comes back again to the answer is though threes types of supply responses.

Q If Washington is a tough state to do business or come into business here, I guess I'm still a little bit unclear as to what would be the major driver to want to bring competition to a state where it is going to be very tough to do business successfully.

A I'm not sure. I think - I think when you have vigorous competition, that's when it becomes toughest to do business. If you - you know, imagine the restaurant business, very tough business. You want to open a new restaurant, very difficult to get started.

It is - it is a good thing, in my view, and I think most people's view to have a tough, competitive market because then the prices that - keeping premiums in check is really what most of us care about. And I think that's what is going on in this state. Nobody has excessive profitability, from what we can tell.

Q Does that mean it is less likely that major external competitors, not-for-profit or for-profit, would come into the State of Washington?

A A new one.

Q A new one.

A I do believe it is less likely. When - you know, when any of us - and whether it is our personal finances or the businesses we run or whatever, when we think about where should we put our capital, where should we put our savings,

we are trying to think of what is going to get me the best return, whether that is a house or a mutual fund or something.

Businesses are really no different, they are going to look for opportunities where - where they think there is something missing. Either prices are too high, products are very low quality, service is really bad. Then you know you have an opportunity to come in there and win some business.

When prices are not high and quality is good and service is good, then you will look in other directions probably to do your investing first. So I would think that the more competitive the state, that is good for the consumers of that state, but it is less likely that that's the first choice of, say, a national for-profit or not-for-profit carrier.

Q I'm curious in - from your experience in looking at the not-for-profit and for-profit companies doing business in a particular market, is there more refined underwriting and risk selection processes in effect on the part of for-profit as opposed to not-for-profit or do you think that they are essentially comparable?

A I do think that the natural inclination is to say incentives can be different. It is a comfortable place to be. But what is ignored is the fact that - the fact that competition won't let even the not-for-profit - let me actually start

differently. You could be a not-for-profit with the most noble of missions and you may want to maximize profits because you have this noble mission you want to accomplish. So a not-for-profit could behave exactly like a profit-maximizing for-profit company, in that respect.

But I would say in the State of Washington neither kind of firm can earn those monopoly profits even if it is to do good things or if it is to put it in their pockets. So it is the competitive constraints that will make it so that not-for-profits have to do the kinds of things that Premera had to do, which is to pull out of certain products, pull out of certain geographies because the margins are thin.

Q One of the concerns that I think a lot of people have is that as healthcare has evolved, particularly in the 1990s, toward tighter, more refined underwriting practices and risk selection practices, that it has driven up the number of people without health insurance.

Is this something that we should worry about, from your experience, relative to a - to a - the changes in going from not-for-profit to for-profit?

A I don't think it has to do with not-for-profit or for-profit. And the example I would give you is Washington's own experience in the individual market. That was a case where because of the - as I understand the general problem, because of the underwriting rules or

inability to underwrite within at least some sorts of bands, the ones that pulled out were all not-for-profits.

I don't think it has anything to do with for-profit or not-for-profit. If you have got a tight competitive market and you simply cannot afford to be adversely selected year after year after year, that's what I think contributed to your crisis in the late '90s.

Q I certainly appreciate that for the individual market and it really was more of an artifact of the regulatory requirements and statute and law at the time. But I'm thinking of where you have a competitive market today, the differences that take place as part of competition that you wind up with tougher underwriting and more critical risk selection being more of a concern as opposed to some of these other factors.

A Again, if you think - if - as I believe, competition is a driving force that is forcing to you watch every penny, forcing you to focus on the bottom line whether you are not-for-profit or for-profit, it is the same calculus.

In other words, the underwriting has to be stringent because - this has happened to Blues in many parts of the country where they used to literally be the insurer of last resort. A lot of them have - you know, there has been a whole transition where the Blues are no longer the insurer of last resort because they are so adversely selected they

got into trouble. So now they got premium breaks for it and some other things for it way back in the past, but most - we - we are well beyond that in most states.

And I think that the bottom line of all that is that every company, for-profit or not-for-profit, has to watch its bottom line and therefore has to go to - I don't mean that these are wrong underwriting standards. I don't think that's what you mean by your question. It just means that they are tight in their underwriting standards.

Q And is the outcome that the number of uninsured go up over time and what other major drivers for that are taking place? I mean, there is a number of them, but how much is attributable to the underwriting and risk selection as a part of that outcome?

A I think the kind of solution that happened in the individual market here, which is basically to create a risk pool, is likely to be the way that that gets handled.

There will be people who will be high utilizers. There will be people with chronic conditions. If they are not protected - if you think about how we do it in the United States, we are most successful when we have a large group - a large employer group. And that large employer group shops for the insurance in the sense of saying, "I don't care if we have, you know, mothers who may have premature babies who cost a lot or people with HIV that maybe cost you a lot, If

you want my group, you have to take us all."

So we essentially have a cross-section of the population. And the insurer is very comfortable with that because they are going to get a cross-section of the population. So it is when we get to the small groups and individuals that have defined health problems where one premature baby can really affect a small group, can really - if there is any experience rating allowed.

So what does a regulator do? A regulator says, "I have to protect that with some sort of community rating provision." And - and you then get into the kind of community rating that you do in this state, and a lot of other states do, and that usually works.

But in the case of your individual insurance crisis previously, it was, in a sense, overdone. You had to have a safety valve. The safety valve, in my judgment, will end up being the kind of risk pools that you adopted for the individual - maybe in small group that ends up being - if there is too much risk selection going on, that may be a solution. But I think it is - it is a rock and a hard place in that respect.

COMMISSIONER KREIDLER: Thank you very much.

JUDGE FINKLE: Follow-up?

MR. TAUSEND: No follow-up.

MR. ELLIS: No follow-up.

MR. COOPERSMITH: None from here, Your Honor.
JUDGE FINKLE: Thank you. Please step down. Perhaps a few minutes earlier than the usual break, but we can get started with the next witness or take a break depending on --
MR. KELLY: I think a break would be good, Your Honor.
JUDGE FINKLE: Let's do that.

(Brief recess.)

JUDGE FINKLE: Please call your next witness.
MR. KELLY: Mr. Lusk.

JERRY LUSK, having been first duly sworn by the Judge, testified as follows:

MR. KELLY: And just by way of introduction, this will be a much briefer introductory question and answer than we have been seeing in the past.
JUDGE FINKLE: Excellent. Well done.

DIRECT EXAMINATION

BY MR. KELLY:

Q Mr. Lusk, would you state your name?

A Jerry Edward Lusk.

Q Okay. And would you state your position and your business address?

A Yes. I'm a consulting actuary and a principal with the firm of Milliman, Incorporated. I work out of the Atlanta, Georgia office, which is located at 945 East Paces Ferry Road, and that's Atlanta.

Q Could you tell us about the work that your firm Milliman does?

A Yes. Milliman is a consulting - is an independent consulting firm that began in Seattle in 1947. We presently have over 1700 employees located in more than 30 offices in the United States and several countries around the world.

While our primary focus is actuarial work, we do other types of consulting, but primarily we are recognized as a - as a leader in the actuarial consulting industry.

Q And how long have you been with Milliman?

A I joined Milliman in 1977 the first time after serving as director of actuarial services for Blue Shield in Ohio. And I left Milliman in 1986 to be the chief actuary of Blue Cross/Blue Shield of Georgia. And I was there three years. I was promoted to the executive vice-president and chief

financial officer. And I rejoined Milliman at the end of 1989. And, at that point, I reopened the Atlanta health practice for the firm.

Q Okay. And could you describe your education and qualifications?

A Yes. I have a bachelor's of science degree in applied mathematics from the University of Colorado. I also have a bachelor's of science degree in business administration from the University of Colorado. And I have a master's in business administration from the University of Dayton.

Q And are you an accredited actuary?

A Yes, I am. I am a member of the American Academy of Actuaries. I am also a fellow with the Conference of Consulting Actuaries. And I do actively maintain my continuing education credits required by the American Academy of Actuaries to be able to offer actuarial opinions.

Q Okay. Are you the author of any books?

A I am the associated editor for the textbook "Group Insurance" and I have authored one of the textbook. We are the fourth edition of that textbook. It is kind of a comprehensive compendium of many actuarial underwriting related topics.

Q Okay. Could you describe the range of your work experience over the years at Milliman?

A Over the many years I have worked extensively with Blue

Cross/Blue Shield plans. I have also worked with nonBlue health insurance companies, quite a few HMOs, both start-up and ongoing. I have worked with some plan sponsors, worked with some provider organizations, quite a wide variety of companies.

Q Okay. What type of consulting work have you done?

A Pretty much every facet of actuarial underwriting type work. I have focused a lot of the rating side, rating system development. I've also done a lot of work on the actuarial liability side, financial forecasting, trend analysis. Pretty much every aspect that is fairly common in our business.

Q Okay. Now, your prefiled direct and prefiled responsive testimonies have been served and filed in this proceeding. And I have asked this of all the other witnesses. Do you adopt that testimony?

A I do.

MR. KELLY: And Mr. Lusk's prefiled direct is marked as hearing Exhibit P-44 and his biography is P-45. And - let's see. And with his adoption of the testimony, I move to admit that - those exhibits. And I believe he does not have prefiled testimony; is that correct?

THE WITNESS: I'm sorry?

MR. KELLY: Do you have prefiled responsive testimony?

THE WITNESS: I do not.
MR. KELLY: Okay. Just prefiled direct and his biography.
MR. HAMJE: No objection to P-44 or P-45.
MR. COOPERSMITH: Likewise, Your Honor.
JUDGE FINKLE: Admitted.
Q (BY MR. KELLY) And you also submitted expert reports in this proceeding?
A Yes, we have. We submitted a report in November of 2003 and then we did a supplemental report in March of 2004.
Q Okay.
MR. KELLY) and I will move to admit hearing Exhibit P-46, which is the original report, which is the original, and P-47, the supplemental report.
MR. HAMJE: No objection.
MR. COOPERSMITH: No objection.
JUDGE FINKLE: Admitted.
Q (BY MR. KELLY) And I take it you adopt those reports?
A I do.
Q Okay. Thank you.
I would like to ask you about the first area of your expert testimony, which involves the evaluation of the likely premium rate impact, if any, of the conversion of Premera.
And my first question is how did you go about evaluating

any premium rate impact?

A Okay. We - we essentially modeled the margins and resulting premium rates for Premera during a five-year projection period beginning in 2004 and ending in 2008 under two scenarios.

The first scenario we defined as the without conversion approach, and that's essentially assumed ongoing operation. And scenario two was the - would have been the conversion scenario.

Q Okay. And what was your conclusion after doing that model?

A It was our conclusion that the Premera's conversion is not likely to have any material impact on its premium rates.

Q And what did you find, actually, when you compared the results with the projections for those figures under the two scenarios?

A Based on the comparisons during the five-year period, we found very little variation, very little differences in the rates under the two scenarios.

Q Okay.

A We - that's basically it. In fact, actually, we found that the rates under the conversion scenario, scenario two, were slightly lower than the rates under the scenario one option.

Q And what was the percentage of difference then?

A It was about a half of percent.

Q Okay. And if I could direct your attention to Exhibit P-46.

Perhaps we could - without - I guess we could have all of the - the attorneys look at their copy of P-46 if you want, and the Commissioner.

And do you have P-46?

A Yes, sir, I do.

Q And if you would turn your attention to Page 5. And does the - the box with the comparison figures reflect the projections with and without conversion?

A Yeah, they do.

Q Okay. And then the difference between the two is shown on the third line; is that correct?

A Right, the 0.5 difference, yes.

MR. KELLY: And just for the record, I would note that the actual premium data is, I believe, AEO data and has not been made public, but I think we - if we are going to talk about it, we can do it without having to close the hearing by - unless that turns out to be necessary.

JUDGE FINKLE: Let's go ahead. Thank you.

MR. KELLY: Okay.

Q (BY MR. KELLY) Your second area of expert testimony touches on RBC benchmarks. And when you talk about RBC benchmarks, are you talking about the same thing that Ms. Novak described as RBC levels?

A Yes.

Q Okay. What did you investigate regarding premiums and RBC

benchmarks?

A We - our models were used to make some determination if the margins - excuse me - the margins in the current Premera premium rate projections would be sufficient to meaningfully increase the surplus of Premera in relation to its benchmark target.

Q And what did you find when you made that examination?

A We found that the current margin, or at least the margins observed in the most recent couple of years, would not be sufficient to meaningfully increase surplus in relation to the RBC benchmark.

Q Okay. Did you make any other analysis regarding Premera's premium rate structure?

A We did.

Q And what was that?

A We looked at each component of the premium rates. And when I talk about components, I'm talking about - and, again, I guess in terms of being an actuary or an underwriter, the premium dollar can be split into several buckets. One bucket being the bucket to pay for claims costs. That's probably the - that's typically the largest piece of the rate, the largest component.

The second component would be the administrative expenses. And then we have some smaller pieces, broker commissions, high risk pool subsidy, claim reserve flow and

a couple of other - like, premium tax being one, And last but not least, contingency and risk charge.

So we looked at each component to make some determination if the conversion will have any impact on those components.

Q Okay. And what was your conclusion?

A Other than the relatively small increase in the premium tax in Alaska, we felt that the conversion would not likely have any material impact on any of the rating components.

Q Okay. And I would like to now turn to the next area of your expert testimony. Did you review a document entitled "Washington Economic Impact Assurances" that was part of Exhibit E-8 to Premera's Amended Form A?

A I did.

Q Okay. And did you make your analysis of the impact of those assurances in your supplemental report?

A Yes, we did.

Q Okay. Now, the termination date for those assurances is two years. What is your conclusion about any time requirement that would go beyond the two years of those assurances?

A Well, our conclusion was that anything beyond a one- to two-year period for any type of a rate-related assurance is essentially impractical and not prudent and something we would not advise.

Q And what - what is the - is there any significance to the

fact that Premera would have that assurance requirement whereas its competitors would not?

A Well, that's a key consideration. It is a dynamic market. We can't predict changes. We try to avoid long-term rate-regulated guarantees, because if the competition doesn't have the same restrictions, it could clearly put the company at a competitive disadvantage at sometime during that period. So we can foresee one to two years, but going out three years makes it very difficult.

Plus, one of the other notes that we referenced in our report was that groups, of course, in our terminology renew on a - typically on a 12-month cycle basis. And if you are a full-line insurance company, your business renews throughout the year. Some groups renew in January, some groups renew in February. It is all tied to when these groups enroll.

If you have a two-year assurance guarantee, effectively you are staggering much into the third year because if you - let's take an example here. Let's say we started the assurances in January of 2005. Effectively we would not be able to change or impact any of the rates for groups until somewhere into 2007. Because if you take a group that renews in December of 2006, kind of the last month of the two-year period, effectively they are locked into the guarantee or the assurance until December of that third

year. So, effectively, a two-year set of assurances is much like a three-year set of assurances.

Q So you disagree with PwC's recommendation that the assurances should be in place for a minimum of three years?

A Absolutely. Unless the competitors had the same restrictions, that would be an unsound business practice.

Q And the final area I would like to ask you about is in regard to PwC's February 27, 2004, report addendum on its economic impact analysis.

In that addendum it concludes, quote, "Among the ASC business line in particular, the current expense allocation model suggests that administration charges would have to increase significantly to reach target margins without subsidization from other product lines," end quote.

Do you degree with that conclusion?

A No, I do not.

Q And why do you disagree?

A Well, I believe Premera, like many companies, strategically prices all of their business segments. And to - I believe the quote from PwC was that Premera would need to increase their ASC price on average 28 percent. That just obviously would not be a workable solution in the marketplace.

Those products are priced competitively. The actuarial department of Premera takes a lot of effort - makes a lot of effort to make sure that all of its products are priced

appropriately and that the administrative expense budget is absorbed through its entire product line.

Q Okay.

MR. KELLY: That concludes my direct exam. Thank you.

CROSS-EXAMINATION

BY MR. HAMJE:

Q Good afternoon, Mr. Lusk.

A Good afternoon, Mr. Hamje.

Q Mr. Lusk, you have some personal experience with the actuarial department at Premera, do you not?

A I do.

Q In fact, you started working with Premera --

JUDGE FINKLE: Excuse me. Is your mic off by any chance?

MR. HAMJE: How's that?

JUDGE FINKLE: Better.

MR. HAMJE: No wonder you didn't hear me.

Q (BY MR. HAMJE) I guess, Mr. Lusk, were you able to hear me?

A I did.

Q Okay.

A Of course, I don't hear well anyway, so I was probably reading lips.

Q But you have been working now for Premera for about six years; is that right?
A That's correct.
Q You started working with Premera back when Andrew Wang was the actuary - chief actuary?
A I did.
Q And for about two years when you were there you were involved in reviewing all aspects of rating and underwriting to help improve - or work to improve the financial condition of Premera; is that correct?
A I was very activity involved for about a two-year period, yes.
Q You weren't an employee, you were with Milliman?
A That's correct.
Q Would it be fair to say that you were working fairly aggressively with Premera during that time?
A Yes.
Q And since that time you have had an ongoing involvement with the company; is that right?
A Yes, I have.
Q In fact, when Ms. Halvorson came onboard, who is the current chief actuary, you helped her to phase into her current position; is that right?
A I did, although she didn't need a lot of help.
Q Both over the last - what? - I guess two or three years you

haven't done quite so much work with Premera; is that right?
A That's correct.
Q Though Milliman has still been involved in some projects each year; is that right?
A Yes, we have.
Q For instance, Milliman has reviewed the yearend monthly claims liability; is that correct?
A Yeah, the yearend liability, yeah, on December 31st each year.
Q And there has been some smaller projects that have handled from time to time; is that right?
A Yes, sir.
Q And also Milliman was involved in a fairy extensive 18-month project that ended almost two years ago; is that right?
A That's true.
Q And you expect to obtain additional engagements from Premera, do you not?
A Not necessarily.
Q Well, do you expect that Milliman will continue to be utilized from time to time by Premera?
A One would hope so, yes.
Q Did you not tell me during your deposition that you - that you thought there was a better than even chance that Milliman will continue to do the claims liabilities reports?
A I think there is a good chance, yes. Probably better than

even, but no guarantee.
Q I understand. I understand also that the Milliman Seattle office is doing a small claims audit project for Premera right now; is that right?
A I believe that has been completed, but they did do a small project recently.
Q Was that in effect back in November when I took your deposition?
A I believe it was, yes. I was not personally involved in that project.
Q And isn't it true that you also provided the statement of actuarial opinion or certification on Premera Blue Cross's 2003 annual statement?
A I did.
Q I wanted to ask you about some of your testimony. You talked about the study that you did as the first part of your - of your engagement, is that right, the evaluation of likely premium impact of conversion and you developed some models?
A Yes.
Q How did you factor in Premera's ASC business into that?
A The ASC business was included in the model and it was - the - the input items for the ASC business were taken directly from the Form A filing. And we assumed that those essentially would not change throughout the five-year

projection period. But, again, the one qualification - the Form A filing took data through 2007 and we used kind of ongoing trends to include 2008.

Q Would it be fair to say that the ASC business - and by the way, when we are talking about ASC, what is that? What does ASC stand for?

A The general term stands or "Administrative Services Contracts" or it's sometimes called ASO, sometimes called self-funded. It includes business essentially where Premera would not be on the insurance risk, that they are paid for claimed expenses plus an administration fee.

Q Isn't it a very useful way for a company to make use its of infrastructure for paying claims and administering policies so they can go ahead and use that business without - use that infrastructure without taking on any additional risk?

A It certainly is. Plus most large employers prefer to take their own health insurance risk and not pay an additional premium surcharge for an insurance company to take that risk.

Q Like Microsoft?

A Microsoft would be an example, certainly.

Q Isn't the ASC a significant portion - proportion of Premera's business at this time?

A It is, yes.

Q Are there premium equivalents for ASC business?

A Yeah, there certainly are.
Q Could you generally describe premium equivalent?
A Premium equivalent, in my definition, would be the sum of claims and administrative expenses plus any profit loads that might go along with the agreement with the employer.
Q Would that be like maybe a percentage add-on?
A I think that typically would be, yes, or a per capita charge of some form.
Q Now, you do agree with PricewaterhouseCoopers that increasing the operating margins one to two percent is certainly not appropriate for Premera to consider doing at this time; is that right?
A Yes.
Q And you certainly agree that an actuary who is involved in rate filing on behalf of a carrier must be familiar with the relevant law; is that right?
A I do.
Q You yourself have not been involved in any rate filing for quite sometime, for maybe 10 to the last 15 years; is that right?
A Any - I would not say that's true.
Q Well, any - any real hands-on experience in rate filing?
A I have had some hands-on experience with - well, with Premera several years ago. Not recently, but several years ago. And some of my other clients I, from time to time,

will be actively involved in reviewing the filing.
Q When you were working with Premera, was this the time that you were involved in some of the rate filings at that time?
A Yes.
Q Was that more than two years ago?
A Yes, it was.
Q Are you currently knowledgeable about rate filing law here in the State of Washington?
A I wouldn't say that I'm - I could quote a chapter in verse, but I'm certainly aware of the regulations and I have reviewed them.
Q Would it be fair to say that your familiarity with rate filings here in the state is based upon your knowledge from the past and your current reading and studying of the statutes and regulations related to them?
A That's true, yes.
Q Mr. Lusk, do you have a copy of P-46 in front of you?
A I believe I do.
Q Would you please turn to it, please?
A I have it.
Q If you could turn to Page A-4. I'm sorry, A-10.
Is it correct that from Pages A-8 to A-18 you cite relevant technical advisories, statutes and regulations related to rate filing in the State of Washington?
A That's correct.

Q And I want to just draw your attention to the one on Page A-10. You cite RCW 48.19.040; is that correct?
A That's correct.
Q That citation was included in error, was it not?
A I believe it was. I don't believe that applies to Premera any longer.
Q Did it ever apply to Premera?
A I don't recall.
Q Does that provision apply at all to health plans?
A I really can't say. I focused more on 48.43 and 48.44.
Q If we go back to Page A-4 then, please.
A (Complying.)
Q If you would take a look at the second bullet point from the bottom, the first sentence reads - it says, "Rates for individuals and small group products are subject to OIC review." And then it says, "The OIC can disapprove rate filings that do not comply with applicable regulations."
Did I read that correctly?
A Yes, you did.
Q Are you suggesting that the OIC may disapprove rates for individual products?
A I believe they still can --
Q You --
A -- if they don't comply with the law.
Q You believe that the OIC has the authority to disapprove

individual rate filings?

A I believe they can intervene on filings if they do not meet the minimum loss ratio requirements and do not meet the filing requirements. The intent of the law, though, is to avoid a lot of intervention on the individual filings so it's taken out of context here.

But I believe the Insurance Commissioner's office is still the authority to intervene if a carrier is not complying with the law that currently applies to the individual products.

Q Well, let me ask you: Are you making a distinction between approving or disapproving rates and then taking action if a carrier is violating the law? Is that what you are saying?

A Yes.

Q So would it be fair to say that really the - maybe the statement that you made in the report went a little bit too far and should not have gone so far as to disapprove, but should have said that the Office of Insurance Commissioner could just take action against the company and sanction the company for failure to comply with the law?

A That's a reasonable assessment, yes.

Q But I do want to go ahead and ask you about - if you go to Page A-11 of your report, if you look under Subsection 2 and there the provisions state, "A healthcare service contractor" - and Premera Blue Cross is a healthcare service

contractor, is it not --
A Correct.
Q -- "shall file, for informational purposes only, a notice of its schedule of rates for its individual contracts with the Commissioner prior to use."
Is that right? Is that my reading?
A That's correct.
Q Is that correct?
And if you would look at - on the next page, on A-12, Subsection 4, and that - and that provision states, "The Commissioner may not disapprove or otherwise impede the implementation of the filed rates."
A I'm fully aware of that statement, yes.
Q If you would refer to Page 2 of P-46, please.
A I have that.
Q And now I have, too.
A Okay.
Q On that page you discuss premium rate components and refer to a graph. And there is a graph referred to on that page; is that right?
A Yes.
Q And, in fact, I'm sorry, it is contained on that page?
A Correct.
Q The graph is intended to illustrate the general components for premium rates; is that right?

A Yes, not in any direct proportion. It is illustrative in nature, but --
Q But it is the big picture?
A Right. It is simple but effective way to kind of highlight what rate components are all about.
Q If you were to use the same method, the same kind of a graphing method to illustrate the rate components by line of business, it is likely that the values for those components would differ from your graph; is that right?
A Right. Some of the components could completely go away. Some of them could be larger.
Q And, in fact, they would also vary from business line to business line; is that right?
A What are you defining as a business line, Mr. Hamje?
Q Well, let's start with HMO, PPO, small group, large group, individual.
A Right, they certainly could.
Q Yes. And you have a component in there for healthcare costs?
A Yes.
Q Now, that includes provider reimbursement, does it not?
A It does.
Q Would it be fair to say that provider reimbursement comprises the largest portion of that component?
MR. KELLY: Of this illustration, Counsel?

MR. HAMJE: Yeah, let's start there.
A Yes.
Q (BY MR. HAMJE) And in the normal case, that's the case, would it not be?
A Right. And I assume you are referring, again, to the claims that are paid on behalf of the providers when you are talking about reimbursement?
Q That's correct.
A They being reimbursed, they are being paid for the services rendered to the subscribers.
Q That's correct.
A Yep.
Q Now, is it - are you aware of whether or not Premera's small group block of business in Eastern Washington is losing money?
A I have not reviewed that in any recent financial statement.
Q Okay. So you have no knowledge of the current situation?
A I believe I saw some chart presented this week that suggested there were some losses in Eastern Washington.
Q But that - you don't have any independent knowledge about that?
A I do not.
Q And it was not something you studied with your engagement?
A That's correct.
Q One of the topics of - of your report in the segment that is

designated "A," A-1 through A-18 or whatever it was, relates to the economic impact analysis performed by PricewaterhouseCoopers; is that right?

A Yes.

Q And in that particular analysis a - a - a rating alternative was suggested. Do you recall?

A Yes, I do.

Q Have you reviewed that rating - suggested rating alternative based upon Premera's experience?

A Could you elaborate on your question? What do you mean, "based on Premera's experience"?

Q Well, in the context of Premera's experience, in the context of Premera's business.

MR. KELLY: I will object to the form of the question. The PwC report was a hypothetical, so I think that needs to be made clear in any questions that you are asking because it is hypothetical.

Q (BY MR. HAMJE) Well, let me start at it from a different direction. Take a look at Page 4 of your report.

A Okay.

Q Under "Conclusion," your first sentence is, "Based on the foregoing, we believe that it is virtually impossible for PBC" - which is Premera Blues Cross - "or any other significant carrier to use geographic factors to achieve a significant improvement in individual and/or small group

rating margins in Washington."

Did I read that correctly?

A You did.

Q And that is your conclusion based upon your study of the economic impact analysis; is that right?

A Study of the impact analysis and knowledge of the regulations and discussions with the Premera actuarial staff.

Q Did you make any attempt to simulate or model the suggested rating alternative that was suggested in the economic impact analysis?

A I tried to understand it, but it was very difficult to follow, so, no, I did not.

Q So your conclusion is not based upon empirical data, just on your knowledge and experience?

A That's correct.

Q Now, is it true that when an actuary prepares a rate filing, he or she can use actuarial judgment in portions of the rate filing?

A Well, there is also some judgment in the process, yes.

Q And isn't it also true that use of actuarial judgment could result in rates increasing, for instance, in Eastern Washington more than they would decrease in Western Washington?

MR. KELLY: I will object. It is an incomplete

hypothetical.

JUDGE FINKLE: I'm sorry. I didn't track. Can you repeat it, please?

MR. HAMJE: Okay. Sure.

Q (BY MR. HAMJE) Isn't it true that actuarial judgment in preparing rate filings could result in rates increasing, for instance, in Eastern Washington more than they would decrease in Western Washington?

MR. KELLY: My objection is this is an incomplete hypothetical and it assumes that the only thing at issue is actuarial judgment.

JUDGE FINKLE: Overruled. If you can answer it, go ahead.

A I don't agree with that. And I - I'm not sure I completely follow your question, but the general gist of doing something different in the east than you did in the west I don't agree with in terms of the Premera rate filing or any insurance company rate filing that operates on a statewide basis.

We are - essentially the carriers are bound by the regulations that promote community rating and running neutrality of factors. And all the factors need to be actuarially sound, so I don't believe judgment comes into play with those types of factors.

I believe judgment comes into play with factors like

setting trends because trends - trend is an unknown, so there is some judgment in the process of deciding what inflationary factor, which we call trend, in the rating process - but some of the other factors, benefit relativities, the determination of area factors, the geographic factor, the determination of the age factors, those are all based upon statistical analysis and those all need to be applied in a very consistent manner.

Q Then if I understand what you are saying correctly, what you - what you are saying is that there is no way that rates could go up in Eastern Washington more than they would go down in Western Washington?

A Certainly not for the same products.

Q Mr. Lusk, do you have a copy of P-44 before you?

A I believe I do.

Q I believe that's your direct testimony.

A I have it.

Q And if you would please refer to Page 9. And you touched upon this at the closing of your direct testimony today, but I wanted to just talk about it a little bit.

The question I pose to you - and this relates to the PricewaterhouseCoopers report addendum, which is S-21 in this case and hasn't yet been admitted into evidence, but that's the exhibit number.

And the question is posed in PwC's - or

PricewaterhouseCoopers's February 27, 2004, report addendum, in its economic impact analysis PwC concludes, quote, "Among the ASC business line in particular, the current expense allocation model suggests that administration charges would have to increase significantly to reach target margins without subsidizations from other product lines," close quote, and then it goes on.

Do you agree with PwC's conclusion? Did I read that correctly?

A You certainly did.

Q Your initial response, the - your first word is just "no;" is that correct?

A Yes.

Q And then you state Milliman's conclusion after that. Now, I wanted to ask you, in disagreeing with PricewaterhouseCoopers's conclusion, are you suggesting that the administrative charges would not have to increase significantly to reach target margins without subsidizations from other product lines?

A That's our conclusion, yes.

Q Are you suggesting that they would not have to increase at all?

A I haven't studied that in detail.

Q Now, based upon the ASC product line model - first of all, have you reviewed the ASC product line model?

A I have not reviewed it recently. I had been involved in the development of that model in the past.
Q Well, let me pose the question to you and see if you have enough familiarity with it to be able to answer it.
A Okay.
Q Based upon that model, will it reach target margins without subsidization?

MR. KELLY: Object. Vague as to what is meant by target margins.

JUDGE FINKLE: Sustained.

Q (BY MR. HAMJE) Well, does the model contain target margins?
A The - it is little more complicated than that. The - the retention formula that Premera uses, which would be similar to what most carriers would use, various components by type of business, by size of group, by risk, is the role of these components that make up the total charge.

And, again, the focus on any business segment is to be as competitive as possible, but in the overall scheme of things to make sure you are absorbing your entire administrative expense budget and providing for some contribution in your total retention charge to your surplus. So in saying that Premera has acted prudently in the past, this is what they have done. They have aggressively tried to manage their expense allocations to a point where they do have contribution to surplus coming out of their total, what

I call, retention load, which is - retention includes both the profit margin and the administrative expenses and all of the other components such as the premium tax, the high risk pool subsidy, et cetera.

Q So if I understand your answer correctly, the model does contain target margins; is that right?

A It certainly does.

Q And you are aware of what those target margins are; is that correct?

A I'm not specifically aware of those.

Q Okay. Well, are you then - would you not be, then, able to answer my questions because of your lack of familiarity with the target margins?

MR. KELLY: What question are you talking about? It is vague at this point.

Q (BY MR. HAMJE) Well, let me go back to the question again. Are you - based upon the ASC product line model, will it reach the target margins set in it without subsidization?

MR. KELLY: I will object. Vagueness as to what you mean by subsidization.

A I don't --

JUDGE FINKLE: Please specify.

Q (BY MR. HAMJE) Is it not true that when a product line is not necessarily - is generating a loss, that if the profit margin is still above one, the - that means that some other

lines have provided enough profit to subsidize that line that it is - that's the loss?

A That is a reasonable definition, but, again, you have to be careful what you define as a loss.

Q So then with that understanding, can you answer my question or should I repeat it?

MR. KELLY: I would ask that you repeat it because I don't remember it.

JUDGE FINKLE: Yeah, I'm not sure anymore what the question was. I'm sorry.

Q (BY MR. HAMJE) Based upon the ASC product line model, will it reach target margins without subsidization from other lines, if you know?

A I - again, what are you defining as "target margins"?

Q Well, again, I thought we had - you had indicated to me that the model has in it target margins. I'm trying to avoid having to close the hearing. I would like to just talk about them generally, if that's possible.

A Okay. Well, as I explained, again, there - in the entire - when you look at the expense development process for any company, it is very difficult to isolate one line of business and effectively say that line of business is subsidizing another line of business. And there is a big difference between the expense targets that are built into the pricing schedule and the allocation that comes out of

the financial reporting systems, that we discussed during my deposition.

Oftentimes, the two don't tie directly together because, again, I'm not sure there is a perfect financial allocation model. And in reality when you are pricing product, you price them to be competitive in the marketplace. I used the example in my deposition if the only thing I sold was ASC business, if that was my only product line, there are certain companies that only operate in that business segment. I would generally know what the competitive rates were.

If I'm going to compete in that line as a full-line carrier, I need to have an expense formula that is competitive in that segment. Now, it just so happens that when you have a large company such as Premera - and this would apply to any Blue Cross/Blue Shield plan - you are effectively many companies because you are competing in individual, small group, large group, ASC, fully-insured, self-funded.

And, again, there may be pockets on your financial reporting system that makes it appear that you may be subsidizing one product line for another, but that doesn't necessarily mean you are not meeting your expense targets and not reaching your overall margin goals.

Q Well, Mr. Lusk, if you can't tell if one line of business

subsidizes another, how can you tell if a line of business is generating margin?

A Once again, when - when the total retention formula is built, it would have a goal in there for a profit margin for each segment. And that would, of course, be probably very small on something like an ASC segment and much larger on, say, an individual product just by the nature of the risks and the type of business that's involved.

But, again, I haven't studied that in detail. That wasn't, again, the nature of our report. All I - all I answered in relation to this question was did I agree with the PwC report and I do not. I don't - I think it's not practical to think that Premera, or any other carrier, could take a huge segment of business where they have been reasonably competitive - and it is a very competitive market - and raise those prices 28 percent.

And, again, as somebody who has looked at financial allocations that suggests that their segment is losing money, they need to look at a broader picture.

Q In this particular instance, Milliman's conclusion is that Premera has acted prudently regarding pricing strategies for the ASC business line; is that right?

A I believe they have, yes.

Q Are you - you are not aware at all of PricewaterhouseCoopers having accused Premera of acting imprudently with regard to

pricing strategies for this line; is that correct?

MR. KELLY: I will object. It is an argumentative question. I would submit that they are arguing that by continuing to do this it is not approving the business activity. Whether it is an accusation or not, I think is just argument on counsel's part. That's the nature of the dispute here.

JUDGE FINKLE: Let's neutralize the word and see if you can't answer the question.

MR. KELLY: Could you repeat the question, please?

MR. HAMJE: Actually, I'm just reading from his conclusion and the conclusion says that the --

A Are you flipping it around?

Q (BY MR. HAMJE) Yes. I'm just saying that you were not aware of PricewaterhouseCoopers having accused Premera of acting imprudently with regard to pricing strategies?

A I did not see those words in any of the - any of the PwC information that I reviewed.

Q And in connection with your involvement in the certification of the Premera Blue Cross financial - annual statement, 2003 annual statement, you have had a chance to review the annual statement; is that right?

A That's correct, but the focus was on the actuarial liabilities. I did not do an audit of their financial statement.

Q Did you - well, of course not.
A Okay.
Q But you did take a look at it? You did review it?
A Well, we verified that the liabilities that we were certifying to were indeed on the balance sheet, yes.
Q In that connection did you also review the notes to the financial statement that is attached to the annual statement?
A I did not personally review those notes.
Q Do you recall or are you aware that Premera Blue Cross reported a loss in the ASC line of business from operations in 2003 for an amount in excess of 15 million dollars?
A I'm not aware of that.
MR. HAMJE: If I may approach the witness, please?
JUDGE FINKLE: Yes.
MR. HAMJE: I have made a copy of Staff 101, which I would like to go ahead and pass around so everybody doesn't have to go ahead and grab all their books.
Q (BY MR. HAMJE) Mr. Lusk, I have handed you what has been marked for identification purposes as S-101 - Exhibit S-101. And that's a certified copy of Pages 25.10 and 25.11 out of the notes to financial statements of the annual statement for the year 2003 for Premera Blue Cross; is that correct?
A Yes, it is.

Q And in all the years that you have been involved in these - in working with insurance and insurance actuarial - providing insurance actuarial services, I'm sure you are familiar with these forms by now?
A For the most part, yes.
Q And on Page 25.01, there is a chart, is there not?
A Yes.
Q And at the line marked "E," it shows a loss of over 15 million dollars for ASC uninsured plans; is that correct?
A Yes.

MR. HAMJE: At this time, Staff would move that S-101 be admitted into evidence.

MR. KELLY: We have no objection.

MR. COOPERSMITH: No objection.

JUDGE FINKLE: Admitted.

Q (BY MR. HAMJE) Mr. Lusk, I wanted to talk to you for a few minutes about rate assurances that you and Mr. Kelly discussed on your direct.

And you were talking about a particular - I wanted to ask you let's just assume along those lines that the rate assurances were effective as of October 1, 2004. Will you do that with me?
A October --
Q 1, 2004.
A Okay.

Q And let's also assume that Premera of - did not for one reason or another conform its rate filing practices to the assurances. Will you do that as well?
A What do you mean by "did not conform"?
Q Did not pay attention to them, did not follow them. That's just an assumption.
A Okay.
Q How long would it take for the Office of Insurance Commissioner actuary to demonstrate that Premera had not complied?

MR. KELLY: Objection. Such a vague hypothetical as to does that mean when would they find out? I object to the form.

JUDGE FINKLE: It would be more helpful if you could be a little more specific, please.

Q (BY MR. HAMJE) Well, would there be - could there be a need for a period of time for there - for credible experience to be developed before someone would be able to review a rate filing to determine whether or not Premera had complied?
A Well, are you talking about individual or small group or does it matter?
Q It really doesn't matter for my purposes.
A I'm not sure what you mean by - on the small group there is a rate filing that is submitted before the rates are to be used for ongoing business, so the OIC staff does have the

option to disapprove that filing if there is anything in the filing that they feel is not appropriate.

On the individual products, there are filings also prepared, but it is so correctly stated disapproval, which is much more of a challenging process, it is not a - it is not an upfront process like it used to be. Provided that filing is prepared and the loss ratio is within the guidelines of the 74 percent, you know, including the premium tax, then that filing should be, you know - that filing, you know, would be put - those rates would be put into operation.

Now, are you talking about once the experience emerges and we don't have the 74 percent loss ratio? Does that trigger an action?

Q Well, actually --

A I just don't follow where you are going with this.

Q Certainly. And I understand. And I want to ask you maybe in a little different way. Have you - you have had a chance to review those assurances; is that right?

A I did.

Q And do you feel like that you understand them?

A I believe I do.

Q And how would the OIC be able to monitor - what steps would the OIC have to take to be able to effectively monitor Premera's compliance with those rate assurances?

A Well, it would be pretty straightforward in the small group filing. There are benefit plan relativities that are an ingrained part of the filing. There is commission loads that are an ingrained part of the filing. And the assurances are such that Premera for a two-year period would not do something materially different in the east that they do in the west.

Similarly, in the determination of geographic factors, they would follow the same methodology they had in the past and not alter that for two years. I would think it would be pretty direct that the OIC actuary could review the file and say, well, this isn't right, that, you know, last year they had a five percent overall commission load and this year they have eight percent in the east and three percent in the west and that's - that's a violation of the insurance assurances. So I think that would be a fairly straightforward path.

Q Would there be a need from the date that the rate filing is made to - at some point thereafter for the development of credible experience for the OIC actuary to be able to adequately evaluate the compliance of Premera?

A I don't believe so. I mean, again, all of the factors that are in the filing have to be supported actuarially in order to - in order - in the case of the small group to be not disapproved.

And keep in mind, Mr. Hamje, that the filings need to be certified by an actuary before they are completed, both individual and the small group. Like I can guarantee that the Premera actuary, whoever would be signing that statement, would make sure that that filing, to the best of their knowledge, complied with the regulations. And in the case of the assurances, would comply with the assurances.

Q Mm-hmm.

A But, again, in the small group, I think it would be very, very upfront. If - if somebody didn't look at the individual filing because they say they can't disapprove it, somebody might be able to slip something through, but that certainly wouldn't be anything that a certified actuary would allow.

Q There is a difference between the actuarial certification required for individual rate filings and small group rate filings; is that correct?

A I'm not sure if I know the difference. I know they just need to be certified by an actuary.

Q Well, take a look at - take a look at your report on Page A-11 - A-12, please.

Are you at A-12?

A Yes, I am. You are talking about Item D.

Q Yes, I am.

A Certification by a member of the American Academy of

Actuaries --
Q Yes.
A -- or other person approved by the Commission?
Q And that's a different standard than what is required for the small group?
A It is a somewhat different standard, but the intent is for the actuary to comply with the law.

MR. HAMJE: That's all I have. Thank you, Mr. Lusk.

THE WITNESS: Thank you.

MR. COOPERSMITH: Nothing at this time from the Intervenors, Your Honor.

JUDGE FINKLE: Redirect?

MR. KELLY: Yes.

REDIRECT EXAMINATION

BY MR. KELLY:
Q The first questions from Mr. Hamje were about the fact that you have had some prior experience working for Premera.

Let me get first directly to the point. Did that prior experience cause you to do anything improper in regard to the studies and reports that you made in this case?
A Absolutely not.
Q Could you turn your attention to the report, P-46? And if you turn to the - well, I guess we have a cover sheet here

of the report and then on P-46, if you would turn to the next page, I see that it is prepared by yourself, a Mick Diede and a Gary Brace. Were those two gentleman also involved in the reviewing and preparing of this report?

A They were.

Q And was there a peer review internally by your group in regard to this report?

A We have an extensive peer review process before anything of this nature can be released.

Q Okay. Now then, Mr. Hamje turned to a discussion of Page 8 - I'm sorry - turned to a discussion of whether the Commissioner can approve or disapprove individual rate filings.

A Correct.

Q Okay. And is it your understanding that there is a - that any limitation on the ability to approve or disapprove individual rate filings means that the OIC does not - that that provision eliminates or overrides any of the Commissioner's general enforcement authority?

A It certainly does not override his authority.

Q Did you understand Mr. Hamje to be saying that if someone could do something illegal in regard to an individual rate filing, it could come to the attention of the Commissioner and his hands would be tied and he could nothing about it by way of a cease and desist order?

A Absolutely not.
Q Okay. Now, your prefiled direct has this excerpt from the PwC report. If you will turn to your prefiled direct for a minute.
MR. HAMJE: That is P-44?
MR. KELLY: P-44, right.
Q (BY MR. KELLY) Do you have that?
A I certainly do.
Q And Page 9?
A I have that.
Q Okay. Now, you mentioned that there is a difference between expense targets and actual expense allocations; is that correct?
A I'm saying there certainly can be.
Q Right. And expense target is an estimate of what the expense is going to be, am I right there? Or maybe you could define it for me.
A That's correct, right.
Q Allocation is a historical fact looking backwards to see what the expenses actually were and how they were specifically allocated internally by the company?
MR. HAMJE: Objection. Leading.
JUDGE FINKLE: Sustained.
MR. KELLY: Okay.
Q (BY MR. KELLY) Perhaps you can tell us in your own words

what you understand as to what expense allocation is and how it differs from expense target?

A Well, again, expense allocation - I was - I was a CFO for several years at Blue Cross of Georgia. And at that time we had an expense allocation formula, and I had the privilege of being the CFO and the chief actuary.

And so on the one hand, I set an expense schedule that I felt was competitive in the marketplace. On the other hand, I worked with my accountants to have an expense allocation formula that attempted to allocate all of our expenses back to each and every line of business.

And oftentimes the two didn't work in sync. The only place we were in sync was in total, I absorbed my administrative expense budget.

Q Okay. What is your understanding as to the extent to which Mr. Staehlin, who was the person writing this for PwC, was focusing on expense targets when he was making his comparison as opposed to actual expense allocation?

A It would appear that he looked at the expense allocations. And the exhibit that Mr. Hamje passed out from the financial statement would - would lead anyone to believe that that line of business was losing money.

Q Now, what you say in your answer on Page 9 of your prefile is that your conclusion is that Premera has acted prudently with regard to its pricing strategy for the ASC business.

And my question is why do you say that they are acting - come to that conclusion that they are acting prudently despite the fact that there is a report of a loss in that area?

A Well, again, I'm somewhat ignoring the financial statement result. Prudently says to me that overall Premera is doing a good job in absorbing their total expense budget in their portfolio business.

Secondly, they have done an excellent job in selling new ASC business in the last several years and that can only have been done with competitive pricing. Again, that's not below-market pricing. That's pricing that's reasonable in relation to the services being provided.

Q Okay. Now, is it prudent for a carrier to continue to operate a business, line of business which covers all of its variable costs and some, but not all of the fixed costs assigned to that line of business?

A That's - that's not necessarily an imprudent thing to do. Clearly you want to cover what you can define as your variable expenses. And to the extent you are going to absorb some of your fixed overhead, that's great.

And oftentimes, the variable expenses are pretty easy to define. And, again, when someone does act prudently, they make absolutely sure like with anything that they cover their variable expenses and provide some offset to the

overhead.
Q Okay.
A Again, with ASC business, you know, there is no risk there, so that's - you know, that's great.
Q Okay.
MR. KELLY: Excuse me for a minute.
Q (BY MR. KELLY) Okay. Now, when talking about geographic factors, Mr. Hamje asked you about the potential changes to those factors, do you recall that?
A I'm not sure if I recall that specific question.
Q Well, let me ask it this way: Let me ask you to assume that Premera's rates in Eastern Washington and in Western Washington are the same at $100 per person. If three-quarters of the population is in Western Washington and one-quarter is in Eastern Washington, is there any possibility that a change in the geographic factors could result in rates going up more in Eastern Washington than in Western Washington?
A No.
Q Okay. Okay. Well, let me ask you this about the rate assurances: Mr. Hamje apparently had some concern about our - Premera not complying or conforming with the assurances that it said it was going to do. And you explained why in the small - that it would be possible in the small group market - that would be easy to do, to

identify any changes because of the filing requirements.
A That's correct.
Q Okay. The individual is still filed?
A That's correct.
Q And it is certainly available - is it available for the Commissioner to look at those rates and compare them with what Premera has done in the past?
A Absolutely.
Q Would you think that Premera - that the Commissioner's office might think about doing that if it was considering to enforce these economic assurances?
A I think that's what I would do if I was the Commissioner.
Q Now, these economic assurances have been published I think on the website now, have they not?
A I believe they have been, yes.
Q And this an open hearing. For all we know, there is someone here from Regence or other competing organizations that might want to listen and to learn about those economic assurances, don't you think?
A That's correct.
Q Okay. So would that be yet another source where if there were any attempt by Premera not to follow the assurances, someone might well bring it to the Commissioner's attention pretty promptly?
A I would think that would happen.

MR. KELLY: Excuse me.
That's all I have.
MR. HAMJE: No further questions.
MR. COOPERSMITH: Nothing further. Your Honor.
COMMISSIONER KREIDLER: Nothing.
JUDGE FINKLE: Thank you. Please step down.
THE WITNESS: Thank you.
MS. EMERSON: Good afternoon. Before we begin with the next witness, I just wanted to point out that I believe - based on the time estimates that the three parties have given for this witness, we believe that we can complete this today although we would have to go a bit over the 5:00 - maybe 5:15-ish.
JUDGE FINKLE: Let's do that then.
MS. EMERSON: At this time Premera calls Heyward Donigan.

HEYWARD DONIGAN, having been first duly sworn by the Judge, testified as follows:

JUDGE FINKLE: Please sit down.

DIRECT EXAMINATION

BY MS. EMERSON:

Q Can you please state your full name?

A I'm Heyward Donigan.

Q And can you spell your last name?

A D-O-N-I-G-A-N.

Q Can you tell us your employer and your position, please?

A I am executive vice-president for Premera Blue Cross and chief marketing executive.

Q What are your duties as executive vice-president and chief marketing executive?

A I run all of sales, marketing and product development for the Premera family of companies, which includes Alaska, Washington, Oregon and Arizona.

Q Do you have any input into the premium prices that are set by the company for its health insurance products?

A Sometimes I wish I had more input, but yes I have influence but not control.

Q Can you tell us about your educational background since high school?

A I have a bachelor's degree in English from the University of Virginia in 1983 and I have a master's in public administration in healthcare finances from New York university in 1992.

Q And can you summarize for the Commissioner, please, your

professional background.
A I have over 20 years of experience in this business and - starting in '83 as a consultant, mostly - I have worked for a number of different companies in this business, both publicly and nonpublicly traded.
And most recently, before coming to Premera a year ago, I was a senior vice-president of service operations nationally for CIGNA Healthcare. Before that, I ran their transformations project. And before that, I was the sales and marketing leader for the southeast region - president of the southeast region for CIGNA. And before that, I was the senior vice-president in charge of sales marketing and general management for Empire Blue Cross in New York running their managed care operations. And before that, in a number of different sales and marketing functions.
Q Within the health insurance --
A Within the health insurance business.
Q Now, your prefiled direct and your prefiled responsive testimonies have been served and filed in this proceeding. Do adopt that testimony?
A Yes, I do.
MS. EMERSON: Ms. Donigan's prefiled and responsive testimony has been marked as Exhibit P-42 and P-43 respectively. With the adoption of that testimony, Premera now moves to admit those exhibits.

MS. DeLEON: No objection.

MS. HAMBURGER: No objection.

JUDGE FINKLE: Admitted.

Q (BY MS. EMERSON) I understand the purpose of your testimony is to describe, from your experience in the sales and marketing organization within Premera, the competitive environment in which Premera does business within the State of Washington.

In your view, will competition change after a conversion?

A No, not in my view.

Q And why do you say that?

A Well, because our competitors - our competitors continue to be very much interested in our business and the business that our customers are offering to them.

Our customers are the ones that purchase from us, whether they be individual members or employers, and their needs and buying behaviors are the same and they expect the same thing out of any company that they purchase healthcare from, whether it be a for-profit or not-for-profit company. And what we are really focused on is bringing solutions to those members and customers.

Q Let's talk a little bit about Premera's competition. When you are out targeting a prospective customer, what kind of competition do you face?

A Fierce, from my perspective. And even though I must say, coming a year ago to Premera, I would not have thought so necessarily. But we face competition on the individual consumer side - you know, let me split it out into two different consumers. We have those over 65 and eligible for Medicare. And the fiercest competitor that we face in that market is AARP, which you probably know is run by United. And Mutual of Omaha is another fierce competitor in that marketplace.

In the individual consumer under 65, the competitors are numerous, they include Regence. They include - I think potentially could end up including companies like Golden Rule that just got bought out by United.

And then in the small group business, which in some way is our most fiercely competitive market, we compete against Regence. We compete against PacifiCare. I think it is likely we will compete against Aetna in that marketplace in Eastern Washington. Our fiercest competitor is Asuris.

In the mid-market, it is - I really - what keeps me up at night is Aetna. Aetna is our most fiercest competitor in the smaller end of mid-market and in the large business. They own the national account business really in Washington.

Q Can you give us an example or two of some recent tough competitive situations that Premera has been involved in?

A In terms of - oh, in terms of groups, for example? Well, I

guess the one that jumps to mind is Washington Mutual. We were, I think, fortunate enough to be considered one of the four final contenders for the Washington Mutual business when they went out to bid just a couple months ago. And we were the only Blue Cross program considered. It was us, CIGNA, Aetna and united.

United is the incumbent. They have that business now. And Washington Mutual has close to 100,000 members, many of whom are in Washington and some of who are outside of Washington.

And we were really excited because we thought we had a shot at it because we knew that the decision-maker in the company wanted a locally based management team to work with, if he could, and he was really looking for state of the art medical management, care facilitation, health advocacy programs, integrated technology, state of the art technology.

And it became very clear to us when we were going through the initial orals with Washington Mutual and their consultants, that we really did not have that infrastructure complete and able to show the way the CIGNA, Aetna and United did. And so we did not make it to the next round.

And when I talked to the consultant, he said, "You know, you all continue to say, 'We will build if we get the case, we will build it if we get the case,' but you don't have it

there live to show."

And when they did their tours to Aetna, United and CIGNA, even though they were not in Washington, they had these banks of nurses with integrated data warehouses, with technology to support decision-making, with programs already up and running. And that's what they ended up going with, was their - they haven't made a final decision, but they definitely wanted to go with a company that already had those kinds of capabilities.

And I think that's what - if we had the resources, we could - we are as innovative as they are. We could create those kinds of capabilities. We are just not there right now.

Q Ms. Donigan, let's talk a little bit about the company's decision to participate in particular products or particular service areas.

Can you tell the Commissioner, how does the company decide whether it is offering the right mix of health insurance products?

A Well, I think in general we love to be able to offer products to everybody, because the bigger our portfolio, the better it helps us spread our risk and the better able we are to serve broad numbers of constituents that gets our membership large and that helps us with a number of different things, covering our costs, managing our expenses,

making our profits - our products more affordable.

There have been a couple of situations, most notably recently the state account, PEBP, where we had to heavily weigh our ability to manage that business even at break-even. And the state - the premiums the state would have offered us would not have covered nearly even half our cost. We would have lost close to 40 million dollars annually on that account had we continued to offer the state account. So we mutually agreed to part ways. And we had to exit that line of business, which is a hard decision for us. That's one example.

Another example is where the market just decides they are not interested in the product anymore. And so HealthPlus is an example, the HMO. And you have heard this from everybody today. People just don't want to buy HMOs anymore. They're too expensive. They are too restrictive. Consumers don't like the referral process, the headaches that go along with it. Especially they don't want to pay more for it.

So we have seen customers, fewer and fewer buying that product. So we haven't retired that product per se, but we anticipate that we will be shutting that down at some point because we'll have a handful of clients on the product platform and it just becomes too expensive to maintain.

Q What kind of information does the company take into account

when it is trying to evaluate a particular product's potential?

A Well, we would look at the - we would survey our members, our brokers, consultants, employers and assess where they think they are heading in terms of their benefit plan designs.

We are not religious about product. I mean, we will offer whatever a customer is willing to buy assuming it makes logical sense. But if - if customers aren't interested in that product, that is one criteria.

Another criteria would be could we reasonably break even or make a profit on that product or that line of business? And then we would be looking at the potential of how much membership in a certain market is there. Is it really worth the investment in return for the membership in return for the profit potential?

Q And how difficult are these kinds of decisions to exit a certain product line?

A Well, I think exiting a certain product line, if it is market driven, in other words, people just aren't buying it anymore, it is pretty easy because the market has already made the decision.

In terms of us having to exit lines of business, that's always really hard because you know are going to have to give up membership and you know you are going to have to be

a fiduciary to ensuring that that membership can be adequately served by another constituent or stakeholder in the marketplace. And I think we have been pretty careful about doing that whenever we have made those decisions.

Q Would Premera's approach to participating in certain product lines change following a conversion?

A Not at all. I think the fundamentals are the fundamentals and we don't - we continue to look at things as I just described: Is there a market? Can you make some money on it? Is the customer interested in buying from you?

And as I said, I think we continue to want as much mass as we can. That would be true whether we were or were not a publicly traded company.

Q What geographic areas of the state does Premera serve?

A As I think we all know, we serve in - we operate in every county in the State of Washington.

Q And are there circumstances in which the company would consider pulling out of a particular geographic service area?

A I think that would be not in our best interest, so I can't think of a circumstance when we would pull out of a county. Our competitive advantage is the fact that we cover the whole state.

Q Can you tell us a little bit about premiums and the importance of having properly priced products to the

company? What - how important is it for the company to price products appropriately at competitive levels?

A Well, I think it is paramount. And one of the reasons - I mentioned earlier about the influence in pricing and my interest in being influential in that because being competitively priced in a market segment or on a product is going to make a difference between whether we sell business or not.

And just to give you a couple of examples, Commissioner Kreidler, we - in - from 2001 - July 2001 to July 2003, so just this past July - and I came in kind of in the middle of those and saw some of this personally - we lost 32,000 small group members because our pricing was around 15 percent out of the market.

We had some competitors in the small group business who were much lower priced than us. And it is a really price-sensitive business. I mean, as you know, a small group - a small employer is living, to some degree, paycheck to paycheck or, you know, from an individual example, business paycheck to paycheck or business sale to business sale. And so these are consumers or small employers that will switch carriers for five percent, three percent, six percent difference in premium, maybe even on annual basis they will shop. So we lost 32,000 members.

It wasn't until some of our competition raised their

rates and we were able to offer some more affordable products this past July that we were able to stem the tide. And now we are growing again.

In the individual market on our LifeWise program, we had an 18 percent rate increase starting in May of 2003 to reflect the cost of that business and we had 30 percent more cancellations on that consumer line right after that increase than we had had prior.

So it really is a price-elastic market for us. So being competitively priced, especially in the consumer and small group market, is really paramount to being competitive in the business.

Q Would the importance of maintaining competitive premiums change following a conversion?

A Absolutely, because a customer that is price-sensitive, as I just described, they are looking on ehealthinsurance.com or they are looking at their brokers and if we are not competitive, they won't buy from us. They are not going to buy from us all of a sudden because we are publicly traded. They are still looking at the same numbers and making the same decisions for their business.

Q And in response to my last question, would the importance of maintaining competitive premiums change following a conversion, you said "absolutely."

A Absolutely not. I apologize for that. Thank you for the

clarification.

Q Is it - is it feasible, from your perspective, for a health plan to enter Washington and offer a competitive product?

A It is very feasible. In fact, a number of them are doing this - have done this recently. And I think because there are not as many competitors in this market as some of other marketplaces, companies might consider this to be more interesting in terms of to come into the market and compete.

So we have seen a number of different competitors come in recently. It is a mature market, no question. Most are right now in the United States. So there are not a lot of easy, immature markets to enter anymore in the U.S.. This one is really no more difficult.

I worked in New York City, one of the world's most difficult markets, so from my perspective this is a reasonably easy market to enter. I think the one difficulty, as with any mature market, but with Washington as well is the development of a provider network. And that's always harder as you get later into the maturity cycle of the market.

So a lot of what the competitors will do - and you have probably seen this - is they will lease a network. They can come and they can test the waters. If they decide that they really want to go into the market full force, maybe spread out multiple lines of coverage, then they might create their

own network after having tested the waters.
Q And same question with respect to health plans that have current operations in Washington, how easy would it be for that health plan to expand its business into a new line of business?
A That's a lot easier. And I think we heard from Tom McCarthy earlier that they already have infrastructure here ready, already have a commitment into the market, already have the relationships with their distribution channels, so it is much easier to expand geographically once you are already in the marketplace. And I think Regence Asuris is a good example of that.
Q Are there other examples that you can think of?
A Well, I think there are - Aetna is another good example. Aetna has, as you know, been focused in the middle market, as I call it, national account business. We see them now with a renewed emphasis on what we would call or they would call small group, so 300 lives and below. I wouldn't be surprised if they don't go into the 150 life business aggressively.

We see PacifiCare. We hear rumors that PacifiCare is coming into the individual market. We don't know whether that is true. But we hear is lot of this activity about companies that are spreading their wings, so to speak.
Q Do you know whether Pacificare offers individual products in

states outside of Washington?
A Yes, I believe they do. I don't know that for a fact.
Q Okay. A question just - just about market share. Do you put a lot of emphasis on Premera's market share vis-a-vis its competitors' market share?
A Market share, as we have talked about today, is - is an indicator of where you currently and historically have been positioned. And in our business - in the fully-insured business, because we don't see - we can't have visibility, per se, into the self-insured market, which is a pretty sizeable market for us, so I look at it as a snapshot in time.

But when I look at who I'm either losing business to or trying to get business from or competing with side by side on an account by account basis or a consumer by consumer basis, if you look at the spreadsheets that a broker will give to a decision-maker about choosing insurance, the people on the spreadsheet today are not the people on the market pie charts of yesterday.

So market share certainly gives you a sense for who has got the business, but in my opinion doesn't give us a good sense for where the self-insured business is or who is going to get the business.

And so, for example, as I said before, you won't really see Aetna as a big slice on the market share pie, but I

think they will be, particularly if you merge self-insured and fully-insured business together.

So we are really looking at the competitive environment and who is competing with us today and who is taking business and who are we taking business from, if that is makes sense.

Q And one last question for you, what - from your perspective, what do your current and future customers stand to gain from the conversion?

A Well, I think the Wanda (phonetic) example was a good example. Our customers are asking for improved e-Commerce capabilities, health advocacy programs, including health and wellness productivity management programs, because they are worried now about how do I keep my work force healthy, how do I keep them on the job, how do I keep them productive.

They are looking for more disease management programs, more case management, more technology, data warehousing, integration of data reporting, all of which costs us a fairly sizable amount of money up front from a capital investment perspective.

So, to me, that's one big area where we see we need to continue to invest. And it is because our customers are asking for it. And we do lose business. I can only say how much business would we have lost if we hadn't implemented Dimensions. I think we would be in a pretty risky

situation.

So in order to keep up with the big guys that have the resources and the capital to deliver those kinds of solutions, who are in this market, Aetna, CIGNA, United as an example, PacifiCare, we need to continue to be able to make those investments that benefits our customers.

The second thing I think is that every customer wants to know that they have got peace of mind with a well-capitalized company behind them. They don't want to worry about does Premera have adequate reserves. In fact, our ratings, Standard & Poor, A & Best, et cetera, are not what we would like them to be. And our customers do ask. "Why are you a B+?"

And they worry about that because our brokers are concerned about placing business with us with those ratings. And it is because we are not perceived to be adequately capitalized. And that is a concern for our - we don't want that to be a concern for our customers, so I think those are the ways that we will - that this would really benefit our consumer and employer members.

MS. EMERSON: Thank you . No further questions at this time.

CROSS-EXAMINATION

BY MS. deLEON:

Q Good afternoon. I'm Melanie deLeon from the AG's office. I just have a few questions and I will be primarily working off of your prefiled testimony, if you have that.

A Mm-hmm.

Q Basically you state on Page 1 of your prefiled testimony that - and this is on Line 18 - "Many for-profit and not-for-profit companies currently serve the state and to the extent that some may not now compete with Premera or a product line or service area, they could easily do so."

Is that your own personal opinion?

A Well, that is certainly my own personal opinion.

Q Is that based on any studies?

A That is based on my 20-plus years experience in the marketplace, including national experience and my local experience here.

Q But no particular studies that Premera has done?

A Well, I think we have data to point out who the for-profit and not-for-profit companies are that currently serve in the state.

Q I'm focusing more on the words "they could easily do so," that it is easy to do - to compete?

A Yeah, I can't refer to any studies although there may be some. I can only reflect on the fact that we do see

companies coming in and out of the marketplace on a regular basis.

Q On Page 5 of your testimony, approximately between Line 13 and 14, it says, "Participating in lines of business that would lose significant amounts of money is not in the best interest of maintaining the financial stability of the company."

Have I read that correctly?

A That is correct.

Q Could you define what "significant amounts of money" are, in your opinion?

A I'm not sure that I would want to put a number on it per se, but I reflect on lines of business such as the state where the losses would have been such that we would have been in jeopardy of losing our capital position and needing to subsidize, quote, unquote, those losses in order to regain our capital position by doing something that would be illogical for us in terms of pricing in the marketplace on other lines of business.

Q Is the profitability of a product line always considered, whether you will keep it or not?

A Certainly, yes.

Q If a product line isn't profitable, does Premera consider stopping the sale of that product?

A Premera would consider stopping the sale of the product.

Premera would also consider the options that it would be - that would be necessary to make that a profitable line of business. And I think it would depend on how important that was in the marketplace to our customers. If the customers really viewed that as a very important profit, then we would want to do our best to make sure that we could do the right thing to make it profitable for us.

Q So if the product line was currently profitable, you would review it and perhaps try to cut costs to make it more profitable?

A Exactly.

Q And if you couldn't do that, would you continue to keep it if the customers liked it?

MS. EMERSON: I will just object as an incomplete hypothetical.

JUDGE FINKLE: Overruled. Go ahead, please.

A Our long-term goal would be to balance the product portfolio to profitability. And, as you heard earlier, profitability is a bit of a complex equation in it depends on how you account for fixed costs, variable costs, et cetera.

But with - at a high level, we would not continue to sell a product that was - that was a financial risk for us because we would believe that would, long-term, become a financial risk for the corporation. And as I mentioned earlier, our customers want the peace of mind that there is

stable financial corporation behind them. And our fundamental belief is that - and we do see this play out - if a customer is interested in a product and we have the appropriate cost structure behind it, then you can generally make it profitable assuming that there aren't extraordinary circumstances behind it. And there have been, in some cases, extraordinary circumstances.

Q Could you describe some of those?

A The state - again, the state account where the - they were able to charge others premium rates that were extraordinarily lower than what we would have charge to cover the cost of the members that we were serving.

Q How -do you know why they were able to charge such low premiums and --

A Perhaps they were able to subsidize those costs elsewhere.

Q I see.

Does Premera subsidize costs for an unprofitable line by a profitable line of business?

MS. EMERSON: Objection. Vague.

JUDGE FINKLE: Overruled.

A I'm not sure that - I'm - I'm a sales and marketing person, so I'm not really sure that I can answer that technically. From a marketing perspective, from a product management perspective, I look to all products to stand on their own.

And what does that mean? It means that we assume that

all of our products will yield some form of profitability for us and meet certain expectations in terms of covering cost.

Q Were you here for Mr. Lusk's testimony?

A Yes, I was.

Q During his testimony I believe there was an exhibit that showed that the ASC line had a loss of 15 million dollars; is that correct?

A That's what I heard.

Q And so that - the ASC business is not producing a profit for Premera currently, is it?

A If that's what the statement showed. I wasn't able to look at the statement.

Q Then why would Premera continue to carry this line of business if it's losing money?

A Premera has margin expectations for that business and plans to meet them.

Q And --

A And this is an investment in a growing line of business and we do have margin expectations and we do plan to meet them.

Q If at some point they don't meet those margins, would they look at that, the profitability --

A We would certainly look at it. We look at it every year. Our goal here is to reduce our costs such that this will become a profitable line of business and also be able to

show the value to our customers that we can charge the necessary costs that would be appropriate for those lines of business.

Q The profitability, again, wouldn't change if you are for-profit or nonprofit?

A No, no.

Q On Page 5 at Line 18 - I will just read the whole thing. It says, "Premera, through its Blue Cross and LifeWise companies, currently offers products in every county in Washington. Premera Blue Cross offers products in every county except Clark."

Why except Clark County?

A As my understanding - my understanding is that we do offer products under the brand of LifeWise, that we do not have the Blue Shield - I mean the Blue Cross marks in that county.

Q Okay.

A That's my understanding.

Q On Line 21 and 22 you state, "Premera does not have any plans to pull out of any of its current service areas. It would do so only under unusual circumstances."

Can you define what you meant by "unusual"?

A I can't because I can't think of any. So we - we don't - we really couldn't even conceptually think of a reason we would pull out of a county. Statewide is what - the value that we

bring.
Q Okay.
A One of the values.
Q Moving onto Page 6, you state that "Consumers of healthcare coverage are price-sensitive."
Is this - it is prefaced by the question, "in your experience." So is your answer consumers of healthcare coverage are price-sensitive based on your personal experience or some empirical study?
A It is based on my personal experience, my business experience including data related to why consumers change health plans when they change health plans. It is - it is generally - and this is not just here, it is everywhere - it is price. I left Premera Blue Cross to go to another carrier because of price.
And we do - we do have that evidence. This isn't just - this is written documentation that we get postmortem, quote unquote.
Q Do you know how big a market share PacifiCare currently has?
A I do not know that. And I could not suspect it was large because they really are just re-energizing their entry into this market.
Q How about healthcare - or Health Net? Excuse me.
A Health Net, which is their U-select product in the east of Washington, I think it is very small. I don't think they

have been particularly successful entering that market.
Q You testified earlier that you were up for the Washington Mutual business; is that correct?
A That's correct.
Q And that you were one of the final four contenders? It was Premera, United, CIGNA and Aetna?
A Yes.
Q And Premera was the only one that had the Blues mark?
A Correct.
Q And was the only one that was locally owned - or was locally managed?
A Correct.
Q And the Blues mark nor the locally-owned management, those two criteria did not win the business for you, did they?
A They did not win the business, but we would not have been at the table had we not had those two things going for us.
Q You also testified that consumers want peace of mind with a company that is well-capitalized; is that correct?
A Correct.
Q Premera is financially sound; is that true?
A That's the way I look at it.

MS. DeLEON: I have no further questions.

MS. HAMBURGER: Sorry about that. I just have a few questions.

CROSS-EXAMINATION

BY MS. HAMBURGER:

Q You testified in your prefiled testimony that Premera would only drop out of its current service areas in unusual circumstances?

A Correct.

Q But Premera, as you testified before, dropped out of the Public Employee Benefit Program?

MS. EMERSON: Objection. Mischaracterizes prior testimony.

JUDGE FINKLE: Sustained.

Q (BY MS. HAMBURGER) Premera has dropped out of PEBP? That's the question for you, Ms. Donigan.

THE WITNESS: I'm confused about the part of the direction.

MS. EMERSON: I will object as vague in the context of the prior question posed by counsel.

JUDGE FINKLE: This is a new question and if you understand it, please answer.

THE WITNESS: All right.

A Can you repeat the question?

Q (BY MS. HAMBURGER) Premera has dropped out of the PEBP; is that correct?

A That's correct.

Q And it has dropped out of the Medicare Plus Choice Program;

is that right?
A No, I don't believe that's correct. I believe --
Q You don't believe they have dropped out in 2000 of the Medicare Plus Choice Program?
A I'm - I was not here at the time.
Q Okay. And - but you have been here when Premera has recently announced that it is pulling out of the Medicaid Healthy Options and Basic Health Plan?
A That's correct.
Q So it is not doing much competition for government-sponsored business in Washington State other than the Med-Sup program that you mentioned; is that right?
MS. EMERSON: Objection. Vague.
JUDGE FINKLE: Overruled.
A You said we are not doing much for? I'm not sure what that --
Q (BY MS. HAMBURGER) You are not much doing much competition for government-sponsored business --
A Not doing much competition --
Q -- other than the Med-Sup program that you mentioned?
A The federal employees continues to be one of our --
Q In Washington State?
A In Washington State, that's correct.
Q Now, so when Premera decides to drop out of a product line, it doesn't consider its nonprofit mission, does it?

A Premera considers the fact that it is serving the members and the consumers in the State of Washington very seriously.
Q Well, you stated in your prefiled testimony that it considers sales results, broker feedback, competitive environment, medical trends, product line requirements, the effect on providers and short- and long-term potential, profit potential.
A I think I mentioned before that that our primary objective is to serve as many members in the State of Washington as we can continuing to be a viable financial organization and meeting our business goals.
Q So that historical mission of Premera's predecessor corporation in Eastern Washington to serve low-income working families was a consideration when considering to drop Healthy Options and the Basic Health Plan?
A I was not really the leading person in the - I'm a sales and marketing person. I was not really actively involved in the decision on Healthy Options and BHP, so I really don't believe that I'm qualified to answer that question.
Q So you don't know the answer to that question?
A I do not know the answer to that question.
MS. HAMBURGER: I have no further questions.
JUDGE FINKLE: Does Alaska have any questions?
MS. McCULLOUGH: No, thanks.
MS. EMERSON: No redirect, Your Honor.

JUDGE FINKLE: Anything further from the state?

MS. DeLEON: No.

JUDGE FINKLE: Thank you. Please step down. We will see you Friday at 9:00.

(Proceedings adjourned.)

C E R T I F I C A T E

I, KRISTIN D. MANLEY, a court reporter in the State of Washington, do hereby certify that I was present during the foregoing matter and reported said proceedings stenographically.

I, DO FURTHER CERTIFY that the foregoing transcript constitutes a full, true, and accurate transcript of that portion of my stenograph notes so taken and so ordered.

I, DO FURTHER CERTIFY that I am not related to any of the parties to this lawsuit, nor am I interested in the outcome thereof.

Dated this 7th day of May, 2004.

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KRISTIN D. MANLEY

CCR NO. 2211